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April 3, 2017

Hon. Phillip W. Williams
Alabama Senate Fiscal Responsibility and
Economic Development Committee
11 South Union Street, Suite 403-A
Montgomery, AL 36130

Via E-Mail and Hand Delivery

Re: Testimony in Opposition to Mandatory Unitary Combined Reporting (S.B. 67)

Dear Mr. Chairman and Members of the Committee:

The Council On State Taxation (COST) offers this written testimony opposing S.B. 67, a bill which would impose mandatory unitary combined reporting (MUCR) on businesses subject to Alabama's corporate income tax. The bill would also repeal the longstanding option for corporate taxpayers to file a consolidated tax return. Our research shows MUCR arbitrarily assigns income to a state, negatively impacts the real economy, has an unpredictable effect on state revenue, and imposes significant administrative burdens on both taxpayers and the state.

Notably, no other Southeastern state employs MUCR today. In fact, the geographically closest state to Alabama that imposes MUCR is Illinois. Even Illinois' neighbor, Indiana, this session did not even consider MUCR after conducting a thorough study of the issue last year. As such, we respectfully submit S.B. 67 would be counterproductive for Alabama by driving investment and jobs to other states, particularly other Southeastern states.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

COST's Position on Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR. COST's policy position is:

> *Mandatory unitary combined reporting ("MUCR") is not a panacea for the problem of how to accurately determine multistate business income attributable to economic activity in a State. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State. A switch to MUCR may have significant and unintended impacts on both taxpayers and States. Further, MUCR is an unpredictable and burdensome tax system. COST opposes MUCR.*[1]

Problems with Mandatory Unitary Combined Reporting

For corporate income tax purposes, "separate entity reporting" treats each corporation as a separate taxpayer. This is the method Alabama currently uses; it is also used by all other Southeastern states. Like many other states, Alabama also currently allows the filing of a consolidated tax return by companies in an affiliated group, each doing business in the state. MUCR, however, treats affiliated corporations (parents and subsidiaries) engaged in a broadly-defined "unitary business" as a single group for purposes of determining taxable income.[2] MUCR has several serious flaws, and this bill is especially anti-business. It should be noted that the geographically closest state to Alabama employing MUCR for corporate income tax purposes is Illinois – hardly an engine of job growth. The next closest state is West Virginia.

- **Reduces Jobs –** Proponents of MUCR focus on perceived benefits of reducing tax planning opportunities, but they fail to acknowledge the evidence that adopting MUCR hinders investment and job creation. Even if MUCR results in a relatively small increase in net corporate tax revenue, there will be significant increases and decreases in tax liabilities and increases in administrative and litigation costs for specific businesses. Depending on the industry distribution of winners and losers, MUCR may have a negative impact on a state's overall economy. Moreover, economic theory suggests any tax increase resulting from adopting MUCR will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or in-state consumers through higher prices for goods and services.

  The evidence shows states using separate entity reporting have experienced higher job growth than states with MUCR. From 1982-2006, job growth was 6% higher in states without MUCR than in states with it (after adjusting for population changes).[3]

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[1] COST's policy statement is available on the COST website at: http://cost.org/uploadedFiles/About_COST/Policy_Statement/Mandatory%20Unitary%20Combined%20Reporting.pdf.

[2] The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.

[3] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young LLP, May 30, 2008, p. 16.

- **Uncertain Revenue –** Implementing MUCR would have an unpredictable and uncertain effect on Alabama's tax revenues. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. A study conducted by University of Tennessee found no evidence that states with MUCR collect more revenue, and then in a later study found that MUCR may or may not increase revenue.[4] In Maryland, a statutory study found similar uncertainty and volatility,[5] and a legislative commission recommended against even considering MUCR in the future.[6] Further, the Indiana Legislative Services Agency conducted a study last year that concluded any potential positive revenue impact would be only short term and would likely decline to zero in the long term.[7]

  The idea that MUCR will result in fewer corporations filing "zero returns" is a red herring. A substantial number of companies in *both* separate entity reporting and MUCR states may file minimum or zero tax returns, generally due to the application of loss carryforwards, a large number of inactive corporations or corporations required to register for regulatory purposes, or the intended effect of deductions and capital credits.

  It is also important to note, states that have already enacted provisions limiting deductions for related party expenses – like Alabama's existing "addback" statute – can expect significantly reduced new revenue from combined reporting.[8] Alabama has already addressed perceived problems with income-shifting and corporate tax avoidance, and its addback statute has been upheld by the Alabama Supreme Court. Layering on MUCR will create many instances of double taxation due to the application of the addback statute, which already disallows intercompany deductions for payments of royalties and interest. Simply put, for Alabama, MUCR is a solution in search of a problem.

  Members of the Legislature may recall that the Alabama Department of Revenue (ADOR) has called for MUCR several times in the past, and in response the Legislature has rejected the attempt each time. Instead, the Legislature implemented the addback statute and later implemented strict rules on intercompany transfer pricing. In 1998, after study, the Legislature passed a law expressly prohibiting MUCR, which it reenacted in 2001.

- **Regional Outlier** – Fewer than half of the states utilize MUCR, and most of the states that do so are west of the Mississippi River. East of the Mississippi River, primarily the Northeastern states have adopted MUCR, beginning with Vermont in 2006 (prior to which no state had adopted MUCR for two decades). Illinois and West Virginia are the southernmost

[4] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009, p. 34. Another study by the two lead authors commissioned by the National Conference of State Legislatures reached similar conclusions.
[5] Andrew Schaufele, Director, MD Bureau of Revenue and Estimates, Report on Combined Reporting to Governor, President and Speaker, March 1, 2013.
[6] Report of the Maryland Economic Development and Business Climate Commission, Phase II: Taxes, published January 19, 2016, p. 39.
[7] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal Management Analysis, Indiana Legislative Services Agency, October 1, 2016.
[8] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young LLP, May 30, 2008, pp. 2, 11-12.

states east of the Mississippi to have adopted MUCR for corporate income taxes. It is clear MUCR adoption would make Alabama a regional outlier.

- **Administrative Complexity –** MUCR is by definition complex, requiring extensive fact-finding to determine the composition of the "unitary group" and to calculate combined income. This complexity results in uncertainty and significant compliance costs for both taxpayers and the state. Senate Bill 67 makes MUCR even worse by granting "broad discretion" to the ADOR to include income and apportionment factors "on a case by case basis" – an invitation to litigation and the opposite of certainty and simplicity. The bill also provides a nebulous definition of "tax havens," inviting the Department to target foreign jurisdictions at its discretion for discriminatory treatment of any entity "doing business" overseas. Some of the complexities of MUCR are explained in greater detail below:

  - *Determining the Unitary Group:* The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process Clause) concept looking at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of a unitary relationship often significantly influences, or in fact controls, the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process not required in separate filing states and often results in expensive, time-consuming litigation.

  - *Calculating Combined Income* – Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors. From a financial reporting perspective, adopting MUCR is a significant change requiring states to consider ways to mitigate the immediate and negative impact those tax changes have on a company's financial statements.[9]

- **Arbitrary –** Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of

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[9] ACS 740 (formerly FAS 109) requires a recordation of tax expense under certain circumstances that can negatively impact a company's stock price and value.

profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude there is a significant risk MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state. This concern is exacerbated by S.B. 67's unreasonable restrictions on the use of unitary affiliates' tax credits and losses to offset the group's combined income – a clear mismatch which shows this proposal to be an arbitrarily assessed tax increase.

Further, S.B. 67 would implement MUCR beyond the "water's-edge" in a manner that would lead to extraterritorial double taxation of global companies operating in the state. Its water's edge provisions contain several problematic sections that would tax income of non-U.S. companies attributable to legitimate cross border transactions, including cross-border payments (*i.e.*, royalties and interest) that the federal government does not tax because of bilateral tax treaties. Layering on top of this the aforementioned arbitrary "tax haven" classification, S.B. 67 would damage Alabama's competiveness for global companies to invest and create jobs.

Conclusion

Studies show MUCR is the most costly way for a state to raise tax revenue (if indeed it raises revenue) because of its negative impact on job creation and the uncertainty and litigation it generates. This version of a MUCR bill, with particularly taxpayer unfriendly language giving the ADOR broad authority, while limiting the legitimate deduction of credits and losses by affiliates, will not help Alabama attract jobs or investment and should not be adopted.

COST urges members of the Committee to please vote "no" on S.B. 67.

Respectfully submitted,

Ferdinand Hogroian

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director