STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DEPARTMENT OF REVENUE

DIVISION OF TAXATION

Tax Administrator's Study Of Combined Reporting

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March 15, 2014

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DEPARTMENT OF REVENUE

DIVISION OF TAXATION

March 15, 2014

The Honorable Daniel Da Ponte
Chairman
Committee on Finance
Rhode Island Senate

The Honorable Helio Melo
Chairman
Committee on Finance
Rhode Island House of Representatives

I am submitting this report to you in fulfillment of the requirements set forth in legislation approved by the General Assembly and signed into law by Governor Lincoln D. Chafee in June 2011.[1]

The terms of that legislation, codified at Rhode Island General Laws (RIGL) § 44-11-45, require that I report to you – on or before March 15, 2014 – on the results of a two-year study of *pro forma* combined reporting for purposes of Rhode Island's corporate income tax.

In essence, you directed the Division of Taxation to gather corporate income tax returns for two successive years, analyze the data, and use it to help determine the policy and fiscal ramifications of changing the business corporation tax statute to a combined method of reporting.

It is my hope that the information in this report fulfills the requirements that you set forth. Please let me know if you have any questions or require additional information.

Sincerely yours,

David M. Sullivan
Rhode Island Tax Administrator

[1] Rhode Island Public Law 2011, ch. 151, art. 19, § 4

The tax administrator shall on or before March 15, 2014, based on the information provided in income tax returns and the data submitted under this section, submit a report to the chairpersons of the house finance committee and senate finance committee, and the house fiscal advisor and the senate fiscal advisor analyzing the policy and fiscal ramifications of changing the business corporation tax statute to a combined method of reporting.

-- Rhode Island General Laws § 44-11-45(d)

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Disclaimer

The Rhode Island Division of Taxation has made every effort to ensure that the data in this report is reliable. However, the Division of Taxation urges that care be taken when reviewing the data – especially when drawing conclusions, performing state tax revenue projections, and making legislative decisions based on the data.

The Division of Taxation was required to compile the data based solely on the returns as filed by the corporations or their designees; there was insufficient time to audit those returns to ensure that they were complete and accurate.

Moreover, given the nature of the questions and comments that the agency received from tax professionals, corporations, and others during the study period, it was clear that a number of taxpayers did not fully understand all of the requirements involving *pro forma* combined reporting – despite the agency's extensive outreach and taxpayer education efforts (as detailed in Section 9 of this report). Bear in mind that the Division of Taxation sought compliance from corporations and their agents on a complex tax matter, an effort that numerous corporations were undertaking for the first time. As a result, some returns were filed without providing all of the necessary information.

For these and other reasons (more of which are detailed in Appendix E), this report should be read – and the results interpreted – with such limitations in mind.

On February 28, 2014, the Division of Taxation largely ended its process of tallying and vetting the data for this report; the agency does not believe that further such efforts regarding *pro forma* combined reporting would result in any appreciable difference in the overall reliability of the data contained in this report.

Also, the information requested by the Division of Taxation from taxpayers, in accordance with applicable law, did not require full details from filers, so the Division of Taxation is unable to provide answers to all of the questions raised by the data in this report.

It should also be stressed that the data in this report is for tax years 2011 and 2012 – which were, by and large, positive years for business. This report does not reflect the impact of down years on the tax results of combined groups – and the effect that might have on Rhode Island state revenues.

Executive summary

For purposes of Rhode Island's corporate income tax, a corporation must file its return as a single entity – a separate entity – taking into account its own income. That is the case even if the corporation is part of a broader group of corporations in other states, under common ownership, that are together engaged in a common business enterprise – a "unitary business."

Under "combined reporting," a Rhode Island corporation would report on its Rhode Island return not only its own income, but also the combined income of the other corporations, or affiliates, that are under common ownership and part of a unitary business. In other words, a Rhode Island corporation would treat all of its affiliates in other states as if they were one, single company, and combine all of their taxable income in a single pool. The Rhode Island corporation would then use a formula to apportion the amount of the combined income to Rhode Island for tax purposes.

Study period

The requirement to file a *pro forma* combined report applied for two tax years – those beginning after December 31, 2010, but before January 1, 2013.

Thus, for most corporations, the *pro forma* combined reporting filing requirement -- on Schedule CRS of Form RI-1120C -- applied for 2011 and 2012.

To see how combined reporting might work in Rhode Island – and, in particular, what the tax impact might be on corporations and what the revenue impact might be on the State – the General Assembly in 2011 approved legislation, which was signed into law by Governor Lincoln D. Chafee, requiring each corporation that is part of a unitary business under common ownership to file a *pro forma* report for the combined group to include the combined income of the combined group.[2] In other words, Rhode Island corporations were asked to calculate their Rhode Island corporate tax liability as if combined reporting was in effect.

As part of that effort, the Division of Taxation asked corporations subject to *pro forma* combined reporting to calculate their Rhode Island corporate income tax using two separate apportionment formulas: the standard formula under current law which relies on

[2] Rhode Island Public Law 2011, ch. 151, art. 19, § 4. See Rhode Island General Laws (RIGL) § 44-11-45.

three factors – sales, property, and payroll,[3] and a different formula which relies solely on sales – known as single sales factor apportionment, disregarding the property and payroll factors.

In computing tax under the three-factor apportionment formula and under the single sales factor apportionment formula, corporations subject to *pro forma* combined reporting also had to employ two different methods to compute the sales factor. Both methods are named for the appellants in often-cited California court cases: one involving a business named Joyce, the other a business named Finnigan.[4]

Both the Joyce and Finnigan methods involve a concept called "nexus" -- which generally refers to a corporation's presence in a state for tax purposes. (For example, a corporation is generally said to have nexus if the corporation generates income from sources within the state, owns or leases property in the state, employs personnel in the state, or has property in the state.)

Tax rate and revenue

In general, under Rhode Island's corporate income tax, also known as the business corporation tax, each corporation must annually pay to the state a tax equal to 9 percent of its net income.

For the 12 months that will end on June 30, 2014, the corporate income tax is projected to generate about $136 million in revenue, which represents about 4 percent of Rhode Island's projected total general revenues of $3,426,655,000.

Source: Rhode Island Revenue Estimating Conference, November 2013.

Under the Joyce method, "nexus" determinations are made at the level of each individual entity; sales by an entity lacking nexus in Rhode Island are excluded from the numerator for Rhode Island tax purposes.

Under the Finnigan method, the entire unitary group as a whole is treated as the taxpayer for apportionment purposes; all sales of members of the unitary group attributable to Rhode Island are included in the sales factor numerator.

(Overall, the Joyce method generally costs businesses less in taxes and generates less in a state's tax revenue than the Finnigan method.)

Thus, to prepare its Rhode Island corporate income tax return, a corporation essentially had to calculate its Rhode Island corporate income tax liability in two ways: using the standard approach as outlined in RIGL Chapter 44-11, then using a separate set of steps called for by *pro forma* combined reporting as outlined in RIGL § 44-11-45 and Division of Taxation Regulation CT 12-15.

And in the section of the return dealing with *pro forma* combined reporting, the corporation had to calculate its corporate tax liability using three-factor apportionment and again using single sales factor apportionment, with separate calculations involving the sales factor to reflect the Joyce method and the Finnigan method.

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[3] RIGL § 44-11-14.
[4] *Appeal of Joyce, Inc.*, California State Board of Equalization, 66-SBE-070, November 23, 1966. *Appeal of Finnigan Corp.*, California State Board of Equalization, 88-SBE-022, August 25, 1988.

Overall summary of results

Overall, there were approximately 1,621 combined groups that filed *pro forma* combined reports to Rhode Island.[5] Had Rhode Island adopted combined reporting for tax years 2011 and 2012, corporations subject to combined reporting, using the standard three-factor apportionment formula, would have had to pay, in the aggregate, more in Rhode Island corporate income tax, and the State would have gained more in revenue.

Had Rhode Island required such corporations to use the single sales factor in their apportionment calculation under *pro forma* combined reporting, corporations would have had to pay, in the aggregate, still more in Rhode Island corporate income, and the State would have gained still more in revenue. (Please see Table 1.)

Following are the results in a nutshell for corporations subject to Rhode Island's *pro forma* combined reporting, based on unaudited filings of tax returns with the Division of Taxation:

- For tax year 2011, corporations under combined reporting, using three-factor apportionment, would have had to pay, in the aggregate, $23.4 million more in tax (Joyce method) or $25.3 million more in tax (Finnigan method).

- For tax year 2011, corporations under combined reporting, using single sales factor apportionment, would have had to pay, in the aggregate, $49.5 million more in tax (Joyce method) or $54.7 million more in tax (Finnigan method). (The results are solely for those corporations that were subject to *pro forma* combined reporting. The impact of single sales factor apportionment on corporations that were not subject to *pro forma* combined reporting is not included here. Thus, the results do not reflect the overall effect on all corporations of a change to single sales factor apportionment.)

- For tax year 2012, corporations under combined reporting, using three-factor apportionment, would have had to pay, in the aggregate, $21.5 million more in tax (Joyce method), or $23.1 million more in tax (Finnigan method).

- For tax year 2012, corporations under combined reporting using single sales factor apportionment would have had to pay, in the aggregate, $38.6 million more in tax (Joyce method) or $44.4 million more in tax (Finnigan method). (The results are solely for those corporations that were subject to *pro forma* combined reporting. The impact of single sales factor apportionment on corporations that were not subject to *pro forma* combined reporting is not included here. Thus, the results do not reflect the overall effect on all corporations of a change to single sales factor apportionment.)

[5] Division of Taxation results show 1,370 combined groups for tax year 2011, 1,621 for tax year 2012.

Table 1. Capsule results of study on *pro forma* combined reporting		
	Range of aggregate increase in Rhode Island corporate tax (using three-factor apportionment)	Range of aggregate increase in Rhode Island corporate tax (using single sales factor apportionment)
Tax year 2011	$23.4M to $25.3M	$49.5M to $54.7M
Tax year 2012	$21.5M to $23.1M	$38.6M to $44.4M

Dollar figures are in millions. First dollar figure in each row calculated under Joyce method, second under Finnigan.
Source: Rhode Island Division of Taxation

"Winners" and "losers"

From a "big picture" standpoint, the study shows that:

- 6.625 percent of groups, on average, would have seen a decrease in tax;
- 28.75 percent, on average, would have seen an increase in tax; and
- 64.625 percent of groups, on average, would have seen no change in tax.

There were variations by year and by apportionment formula. (Please see Table 2.)

Table 2. Corporations with tax change, no tax change, due to combined reporting			
	% increase in tax	% decrease in tax	% no change
Tax year 2011			
Three-factor apportionment (Joyce)	29%	10%	61%
Three-factor apportionment (Finnigan)	31%	9%	60%
Single sales factor apportionment (Joyce)	35%	5%	60%
Single sales factor apportionment (Finnigan)	37%	5%	58%
Tax year 2012			
Three-factor apportionment (Joyce)	21%	8%	71%
Three-factor apportionment (Finnigan)	22%	8%	70%
Single sales factor apportionment (Joyce)	27%	4%	69%
Single sales factor apportionment (Finnigan)	28%	4%	68%

Source: Rhode Island Division of Taxation

For each year of the study, the greatest percentage of corporations reporting a *pro forma* increase in Rhode Island corporate income tax – and the smallest percentage reporting a *pro forma* decrease in tax – occurred where corporations calculated tax liability using single sales factor apportionment. Within that category, the greatest percentage of corporations reporting a *pro forma* increase in Rhode Island corporate income tax came with the Finnigan method.

For each year of the study, the smallest percentage of corporations reporting a *pro forma* increase in Rhode Island corporate income tax – and the greatest portion reporting a *pro forma* decrease in tax – occurred when the combined groups used the existing three-factor apportionment formula.

Exemptions

A number of entities were not subject to Rhode Island's *pro forma* combined reporting requirement -- and many of them would likely remain exempt were Rhode Island to adopt combined reporting:

- S corporations
- partnerships
- disregarded entities
- public service corporations
- state banks
- national banks
- credit unions
- insurance companies
- any corporation incorporated in a foreign jurisdiction if the average of its property, payroll, and sales factors outside the United States is 80 percent or more.

Without examining the books and records of each corporation involved in the study, the Division of Taxation cannot say with certainty which specific details made some corporations show an increase in Rhode Island corporate income tax, others show a decrease, and others show no change.

However, broadly speaking, combined reporting and single sales factor apportionment tend to favor Rhode Island corporations with a substantial in-state physical presence and with out-of-state affiliates of comparatively small size.

By contrast, combined reporting and single sales factor apportionment tend to increase taxes for a Rhode Island corporation with a comparatively limited in-state physical presence and with out-of-state affiliates that have a comparatively large amount of business activity.

Following are some points that may help to account for the variation among those corporations showing a *pro forma* increase in Rhode Island corporate income tax, those showing a *pro forma* decrease in Rhode Island tax, and those with no change:

- A corporation showing an increase in Rhode Island corporate income tax as a result of *pro forma* combined reporting might have had affiliates in other states that generate substantially higher income – and had to include that income in its results.

- A corporation showing an increase in Rhode Island tax as a result of both *pro forma* combined reporting and single sales factor apportionment might have had out-of-state affiliates of substantial size, while the Rhode Island corporation had a comparatively small presence in Rhode Island.

- A corporation showing a decrease in Rhode Island corporate income tax as a result of *pro forma* combined reporting might have had affiliates in other states showing current year operating losses – and was able to include those losses in its results.

- A corporation showing a decrease in Rhode Island tax as a result of *pro forma* combined reporting using single sales factor apportionment might have had a comparatively large physical presence in Rhode Island, while its out-of-state affiliates were of a comparatively small size.

- A corporation showing no change in Rhode Island corporate income tax as a result of *pro forma* combined reporting might have had affiliates in other states showing little if any income – and the results of those out-of-state affiliates had little effect on the Rhode Island corporation's Rhode Island corporate income tax.

- A corporation showing a decrease in Rhode Island tax as a result of *pro forma* combined reporting might have had a large in-state physical presence in property or employees, but a larger percentage of their sales were shipped out-of-state.

Study limitations

The Division of Taxation's study of *pro forma* combined reporting is by its nature limited in scope; it does not take into account a number of key factors. For example:

- The Division of Taxation's study is based on unaudited corporate tax returns. Due to the nature of the study, the Division of Taxation had to compile data based solely on the returns as filed by the corporations; there was insufficient time to audit those returns to ensure that they were complete and accurate.

- The Division of Taxation's study of *pro forma* combined reporting measures results for only two tax years – years in which businesses in the aggregate were, broadly speaking, recovering from recession. The study did not cover other years, so it does not reflect the impact on tax revenue in years in which there is a general business downturn. In down years, for example, a combined group of corporations engaged in a unitary business would be able to employ losses to offset income – thereby potentially reducing or eliminating the amount of net income subject to Rhode Island's corporate income tax. A study by Maryland illustrates the volatility of the revenue effect of combined reporting: under the Joyce method, an increase in 2006 and 2007, followed by three straight years of declines; under the Finnigan method, an increase in 2006 and 2007, followed by two years of declines, and a modest increase in 2010.[6] A study for the National Conference of State Legislatures (NCSL) concluded that "combined reporting has no direct effect on state tax revenues . . . "[7] The NCSL study further stated that a "small decrease in tax revenues can be expected because of the fall in GDP in high tax jurisdictions and a small increase can be expected in lower tax rate

[6] Letter from Andrew M. Schaufele, Director, Maryland Bureau of Revenue Estimates, to Governor Martin O'Malley, Senate President Thomas V. Miller Jr., and House Speaker Michael E. Busch, March 1, 2013,
[7] "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," William F. Fox and LeAnn Luna, Center for Business and Economic Research, University of Tennessee, November 2010. (Report commissioned by the NCSL Task Force on State & Local Taxation of Communications and Interstate Commerce.)

jurisdictions. Further analysis of how combined reporting affects the economy and tax revenues is appropriate in coming years, and our expectation is that combined reporting will lead to a small increase in tax revenues, but at the cost of a modest decrease in the size of the state's economy."[8]

- The study's results are static. The study focused solely on *pro forma* combined reporting – in other words, tax returns filed as if combined reporting were the law – for two years. Thus, the study does not take into account what actions corporations might take if mandatory unitary combined reporting were the law in Rhode Island. For example, some corporations might seek to reorganize as pass-through entities, and/or locate affiliates offshore. The financial results of such off-shore affiliates might not be reported on a Rhode Island return, depending on how a Rhode Island law mandating combined reporting was structured.

- The North American Industry Classification System (NAICS) is the standard used by federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy.[9] In general, corporations are required to list their principal business activities and their associated codes (based on the NAICS system) on their federal returns. The requirement is designed to classify an enterprise by the type of activity in which it is engaged in order to facilitate the administration of the Internal Revenue Code. Rhode Island statutes do not include such a requirement. As a result, the Division of Taxation is unable to report the impact of *pro forma* combined reporting by industry.

- The study does not take into account the additional staff that the Division of Taxation would have to hire and train in order to implement, enforce, and defend mandatory unitary combined reporting (and/or single sales factor apportionment) – including additional staff for the Corporate Tax section, Field Audit section, Legal Services section, and front office. For example, the Corporate Tax section currently employs a total of only six people – to oversee the filings of literally thousands of corporations and other entities.

- Regarding single sales factor apportionment, the study encompassed only those corporations subject to *pro forma* combined reporting, as was required by statute. Most corporations are not subject to *pro forma* combined reporting. (For additional information about the study's limitations, please see the "Disclaimer" after the Table of Contents, and further details in Appendix E.)

The Division of Taxation compiled this report chiefly for the benefit of the General Assembly and its deliberations. The Division of Taxation makes no recommendations on the major issues outlined in this report.

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[8] Ibid.

[9] The NAICS was developed under the auspices of the U.S. Office of Management and Budget, and adopted in 1997 to replace the Standard Industrial Classification (SIC) system. In general, the codes from both systems identify a firm's primary business activity.

Policy ramifications

The General Assembly asked the Division of Taxation to study not only *pro forma* combined reporting, but also its potential policy ramifications. By mandating combined reporting, Rhode Island would require many C corporations to change the way they have been calculating Rhode Island corporate income tax for the past 67 years.[10]

It is indisputable that mandatory unitary combined reporting is complex. "Lawmakers contemplating a move to combined reporting should consider the immense complexity the reporting regime will introduce for some firms. Further, the complexity comes with a great amount of uncertainty," according to a study for the NCSL.[11] Corporations would have to incur time, effort, and cost to reconfigure their approach to calculating their Rhode Island tax. For one thing, a corporation would have to undergo a thorough and ongoing review of each of its affiliates to determine which would be deemed part of the combined group – and which would be deemed part of a unitary business.

In essence, for purposes of Rhode Island *pro forma* combined reporting, a corporation generally had to take the following principle steps:

1. Determine if it was part of a combined group.

2. Determine which entities in the combined group were engaged in a unitary business.

3. Calculate the group's combined federal taxable income, combined deductions, and combined additions, to arrive at combined adjusted taxable income.

4. Compute the group's combined average net book value of its property, the group's combined sales (receipts) using the Joyce method, the group's combined sales (receipts) using the Finnigan method, and the combined group's payroll (salaries, wages, and other compensation).

5. After taking a number of other steps, the corporation had to calculate its Rhode Island corporate income tax (after any applicable credits) using the standard equal-weighted three-factor apportionment formula, and again using the single sales factor apportionment formula.

6. The corporation also had to calculate its worldwide sales and income.

Although combined reporting is in force in some fashion in nearly half of all states with some type of corporate income tax, and a number of multi-state and multi-national corporations already deal with combined reporting in some jurisdictions, there are

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[10] Rhode Island's corporate income tax as currently configured was established in 1947. (Public Laws of Rhode Island 1947, Chapter 1887)

[11] "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," *supra*.

substantial variations in states' laws – and it is likely that Rhode Island would have its own variations, requiring further adaptation by corporations.[12]

The study also does not take into account the time and effort that would be required especially of small businesses and mid-sized businesses that are not currently subject to combined reporting in any of the jurisdictions in which they do business. Such entities would have to undergo a dramatic shift in the way they report their income for Rhode Island tax purposes. Such entities would likely have to hire additional help – relying not only on in-house aid, but also outside counsel – to determine the effect of combined reporting on their Rhode Island tax liability. The additional time and costs could result in a small business reducing its overall employment in Rhode Island, and taking other steps in the event that combined reporting was to substantially increase its tax liability.

Administrative costs

Implementing mandatory unitary combined reporting would also require substantial administrative costs within the Division of Taxation – including an increase in the number of personnel employed by the Division of Taxation, as well as ongoing education, training,[13] and other costs in order to implement, enforce, and defend such a law. (Combined reporting typically results in a marked increase in litigation.) Additional staff would be needed in the Division's Corporate Tax, Field Audit, Legal, and front office sections.

Even if combined reporting appeared to result in an increase in Rhode Island's general revenues for any given year, any such increase would be offset, at least in part, by an increase in administrative expenses.

The Division of Taxation's Corporate Tax section employs six people to oversee more than 50,000 returns filed annually by corporations, pass-through entities, and others. The staff of six also answers phone calls and e-mails from practitioners and business entities themselves, prepares responses to claims for refunds and internal appeals, works with the Field Audit staff on ongoing examinations, and assists legal staff on formal appeals proceedings.

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[12] If Rhode Island were to mandate combined reporting by statute, the Division of Taxation would urge statutory language which adheres as closely as possible to the Multistate Tax Commission's model statute for combined reporting, and adoption of a Division of Taxation regulation which adheres as closely as possible to that model – chiefly to foster compliance and effective administration. (See Appendix G.)

[13] In order to implement combined reporting effective for tax years beginning on or after January 1, 2011, the District of Columbia was able to rely on the Multistate Tax Commission (MTC) for significant assistance -- the District is a full Compact Member State of the MTC. Still, the District had to incur a $26,000 expense for combined reporting training for its legal, customer service, and audit staff. (The District also anticipates sending staff on a follow-up basis to training, at a cost of $10,000 or so per year.) The Massachusetts Department of Revenue, in order to implement combined reporting effective January 1, 2009, was able to rely on an in-house expert on the subject. But Massachusetts also spent $38,400 to conduct a two-day training session for 55 students.

If combined reporting were implemented in Rhode Island, entities that have never filed returns with Rhode Island would be required to file – resulting in a further burden on existing staff.

Corporate Tax mission

The Rhode Island Division of Taxation's Corporate Tax section is responsible for administering not only the corporate income tax, but also other tax types and fees, including the following:

- partnership returns
- tax on gross earnings of public utilities
- banking institutions excise tax
- compassion center surcharge
- nursing facilities provider tax
- health care surcharges – outpatient facility surcharge
- health care surcharges – imaging services surcharge
- insurance tax
- bank deposit tax
- hospital licensing fee
- political organizations tax
- public service – tangible personal property tax – telecommunications companies

The Division of Taxation's Corporate Tax staff would be unable to take on the additional duties and responsibilities that would arise from combined reporting without at least a doubling of current staff levels.

Rhode Island's full sovereignty membership in the Multistate Tax Commission (MTC) would have to be restored, enabling the Division of Taxation to take advantage of the MTC's expertise in combined reporting and related areas.

The Division of Taxation projects that combined reporting would require, at a minimum, 8.0 additional full-time equivalents (FTEs) in Corporate Tax/Field Audit, 2.0 additional FTEs in Legal, and 2.0 FTEs in the front office/communications area. The estimated cost would be approximately $1.2 million annually, including employee benefits.

In addition, the Division is currently engaged in a multi-year project involving the installation and implementation of an integrated tax system, which is commanding a substantial portion of the agency's time and personnel. The system, when fully operational, will allow the Division of Taxation to offer a broader range of online and other services for taxpayers and tax professionals, among other things – thanks to the continuing support, guidance, and leadership of the General Assembly and Governor Chafee. Still, without a substantial increase in the agency's budget – for staff, education, training, and other expenses – any potential increase in general revenue from instituting mandatory combined reporting would have to be scaled back for state budgeting purposes.

Potential General Assembly considerations

Mandatory unitary combined reporting is not a "flip the switch" proposition. In weighing whether to adopt combined reporting in Rhode Island, the General Assembly would have to invest substantial amounts of time and effort to make a number of determinations that would have sweeping effects on the structure and operations of Rhode Island's business taxation regime for years to come. For example:

- What definition would Rhode Island use to determine whether a group of corporations represents a "unitary" enterprise – and which definition would Rhode Island employ to determine which affiliates of a Rhode Island corporation should be included in a combined group?

- Should Rhode Island employ the Joyce or the Finnigan method for purposes of the sales factor in apportionment computations?

- How would the special apportionment formulas that are currently allowed under Rhode Island General Laws be affected by combined reporting (and any related changes) – and what steps might those entities that currently employ special apportionment take in response?

- Should a Rhode Island law mandating combined reporting extend reporting requirements to a corporation's worldwide income, or only to its income up to the water's edge of the United States? Should a water's edge election – or a worldwide income election – be made available to corporations? In any event, should Rhode Island identify by statute any known tax havens to ensure that income is not sheltered in such havens from Rhode Island corporate income tax?

- How would a group's losses and credits be treated for Rhode Island corporate tax purposes under a law mandating unitary combined reporting? For example, would prior-year losses incurred by affiliates that now have no Rhode Island nexus be allowed to offset income under combined reporting? Could such losses be carried forward or carried back?

- Would Rhode Island continue to offer the corporate income tax rate reduction available under the Jobs Development Act?[14] If not, what would be the impact on those corporations that qualify for and claim the rate reduction?[15]

- Should the members of a combined group for Rhode Island tax purposes be limited to the members of the affiliated group for federal consolidated return purposes – or should the definition of the combined group for Rhode Island purposes be broader, to include additional members?

- Should Rhode Island continue with its standard three-factor apportionment formula, or switch to a formula that gives greater weight to the sales factor – or a formula that includes only the sales factor? Bear in mind that some states without combined reporting have moved to single sales factor apportionment. If the switch is made, should it be immediate, or phased-in?

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[14] RIGL § 42-64.5-1 *et seq.*
[15] For the fiscal year ended June 30, 2013, eight entities received a tax benefit, through a corporate income tax rate reduction, of approximately $15.3 million in the aggregate under the Jobs Development Act, according to the Division of Taxation's "Tax Credit and Incentive Report -- Fiscal Year 2013."

- While considering changes to Rhode Island's apportionment formula, should the General Assembly also adopt market-based sourcing for purposes of the sales factor?

- If Rhode Island were to implement combined reporting, should the State allow certain corporations to claim a deduction – known as the FAS 109 deduction[16] – to offset the impact of combined reporting on their financial statements? If so, should such a deduction be allowed immediately, or phased in over a number of years?

- Should mandatory combined reporting be implemented immediately, or somehow phased-in over a number of years? Should Rhode Island use any additional revenue that might result from combined reporting to structure a corporate tax regime that is close to revenue-neutral, thus blunting the impact on the business community while making the state more competitive with its neighbors – perhaps by employing other corporate tax changes, such as a gradual reduction in the corporate tax rate (as both Vermont and Massachusetts adopted when establishing combined reporting)?

These and other vital, threshold issues would first have to be examined and resolved before any law involving combined reporting could be adopted. Furthermore, no matter how a combined reporting law is structured, it would result in higher taxes for some businesses, lower taxes for others, and no change for others.

The General Assembly would have to weigh such matters while also considering the potential impact such changes might have on the state's overall business climate and on the State's economic development plans – all at a time when the state is still struggling to shake off the lingering effects of what many view as the worst recession since the Great Depression.

[16] Please see Section 5 of this report for additional information on the FAS 109 deduction.

C corporations

Most businesses in the United States are sole proprietorships.[17] Other businesses are organized as partnerships, C corporations, S corporations, farms, or limited liability companies (LLCs), to name a few.[18]

In general, of all the ways in which a business can be organized, only a single slice of the business world -- entities that are organized as C corporations – can potentially be affected by combined reporting. So it is helpful to briefly review what they are, how they operate, and their recent history.

Table 3. Number of different types of U.S. business returns

Type of return:	*Number:*	*Percentage:*
Sole proprietorships	22,659,976	67.5%
S corporations	4,094,562	12.2%
Partnerships	3,168,728	9.4%
Farms	1,924,214	5.7%
C corporations	1,729,984	5.2%
Total:	**33,577,464**	**100.0%**

All figures for 2009. "Sole proprietorships" = non-farm sole proprietorships. Source: "Selected Issues Relating to Choice of Business Entity," U.S. Congress's Joint Committee on Taxation, August 1, 2012.

C corporations are taxed at the federal level under subchapter C of the Internal Revenue Code. They are taxed separately from their owners. C corporations pay federal income tax at the corporate level – at the entity level -- on their income. Their owners pay an additional tax on any income they receive from the corporation in the form of dividends. Thus, C corporation shareholders are said to face double taxation.

In other words, the profit of a C corporation is taxed to the corporation when it is earned, and then is taxed to the corporation's shareholders when distributed as dividends. (Also, a C corporation cannot claim a deduction for the dividends it distributes to its shareholders, and the shareholders cannot claim a deduction for losses incurred by the corporation.)

[17] For tax purposes, a sole proprietorship is indistinguishable from its owner. The business's income and expenses are reported on the owner's individual income tax return.
[18] While most businesses are organized as sole proprietorships, and some as partnerships, S corporations, C corporations, or farms, others may be organized as trusts or in some other fashion.

Pass-through entities

Other businesses -- such as S corporations, partnerships, and many limited liability companies (LLCs) -- do not pay income tax at the entity level. But they do not escape tax. Instead, income generated by the business at the entity level passes through, or flows through, directly to the business entity's owners, shareholders, or partners, who report their share on their personal income tax returns. Such entities are known as pass-through, or flow-through, entities; they typically face a single level of taxation -- adding to their appeal.

While many C corporations exist today, most new businesses are not C corporations; they typically choose to organize and operate as pass-through entities.[19] Nationwide, the number of pass-through entities surpassed the number of C corporations in 1987 and has nearly tripled since then, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies (LLCs) taxed as partnerships.[20] Overall, 72.3 percent of the entities filing Rhode Island business tax returns are pass-through entities; only 27.7 percent are C corporations. (The figures do not include sole proprietorships. Please see Table 4.)

Table 4. Entities filing Rhode Island tax returns: Tax year 2012

Entity type:	*Number:*	*% of total:*
S corporations	24,540	47.7%
C corporations	14,273	27.7%
LLCs	7,328	14.2%
LPs and LLPs	5,353	10.4%
Total:	**51,494**	**100.0%**

"LLCs" category includes 4,343 single-member limited liability companies. "LPs and LLPs" category includes limited liability partnerships and limited partnerships. Source: Rhode Island Division of Taxation.

C corporations account for a far smaller portion of overall business activity nationwide than they once did. In 1980, C corporations generated 78 percent of all business income

[19] This report focuses chiefly on taxation, but there are other reasons involved in the choice of business entity. For example, the corporate form of organization "allows a business to take advantage of a number of benefits not available with other forms of organization. Specifically, a C corporation is not limited in the number of shareholders it may have, the classes of stocks it may issue, the types of shareholders it may have, or the citizenship of its shareholders." (For more on this subject, see "A Brief Overview of Business Types and Their Tax Treatment," Congressional Research Service, June 12, 2013.)
[20] "Selected Issues Relating to Choice of Business Entity," U.S. Congress's Joint Committee on Taxation, August 1, 2012.

in the United States.[21] By 2007, however, C corporations were responsible for only 44 percent of all business income.[22]

Over the same period, partnerships' share of income rose -- from 3 percent to 28 percent -- while S corporations' share rose from 1 percent to nearly 17 percent. The shift, according to the Congressional Research Service, "has resulted in a smaller corporate tax base, and explains a portion of the drop in corporate tax revenues."[23]

The actual number of C corporations has also declined, while the number of partnerships and S corporations has increased.

For example, C corporations accounted for 17 percent of all businesses in 1980, but only 6 percent of all businesses by 2007. Part of the decline can be explained by the Tax Reform Act of 1986, which set the highest individual income tax rate at 28 percent, and the highest corporate tax rate at 34 percent. (Before the change, the top individual income tax rate was typically higher than the top corporate tax rate.)[24]

That gave businesses an incentive to organize as S corporations (whose income generally is taxed at the shareholder level -- at the lower individual rate).[25] S corporations represented only 4 percent of businesses in 1980, but 12 percent by 2007.[26]

The U.S. Treasury asserts that large companies are increasingly avoiding corporate tax liability by organizing themselves as pass-through businesses: Pass-through businesses represented less than one quarter of net business income in 1980, but more than 70 percent of net business income in 2008 – the most recent year for which data is available.[27]

> "While the pattern from year-to-year can be volatile, the overall trend is clear. The ability of large pass-through entities to take advantage of preferential tax treatment has placed businesses organizing as C-corporations at a disadvantage. By allowing large pass-through entities preferential treatment, the tax code distorts choices of organizational form, which can lead to losses in economic efficiency; business managers should make choices about organizational form based on criteria other than tax treatment."[28]

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[21] "Reasons for the Decline in Corporate Tax Revenues," Congressional Research Service, December 8, 2011.
[22] Ibid.
[23] Ibid.
[24] Ibid.
[25] Under subchapter S of the Internal Revenue Code, a qualified small business corporation may elect not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders. (See "Overview of the Federal Tax System as in Effect for 2013," U.S. Congress's Joint Committee on Taxation, January 8, 2013.)
[26] Congressional Research Service, *supra*.
[27] "The President's Framework for Business Tax Reform: A Joint Report by the White House and the Department of the Treasury," February 2012.
[28] Ibid.

An analysis of the decline in corporate tax revenue nationwide is beyond the scope of this report.

Nevertheless, it is important to note that the number of businesses that could potentially be affected by combined reporting -- C corporations -- is small when compared with the overall number of businesses.

It is equally important to note that the pass-through form of business organization is dominant among smaller businesses, but most large businesses -- including many multi-state and multi-national businesses -- are still organized as C corporations.[29]

[29] "Fewer Businesses Are Organized As Taxable Corporations," Tax Policy Center, August 6, 2007.

Section 2

Taxation of C corporations

The federal income tax on the earnings of corporations was established in 1909. Three years later, Rhode Island adopted "a state tax upon corporations."[30] The law also established the Board of Tax Commissioners to administer the tax. The law required that the tax be levied on "every corporation and joint stock company or association, wherever incorporated, carrying on business for profit in this state . . . ."[31]

The annual tax was a kind of predecessor of the franchise tax that exists today.[32] In general, a business added up the value of its shares outstanding and its bonded indebtedness, then deducted the assessed value of its real estate and tangible personal property. What was left over was termed "corporate excess" – and taxed at a rate of 40 cents for each $100 in value. (The levy on corporate excess was in addition to taxes on a corporation's real estate and tangible personal property.)

Rhode Island's corporate income tax as currently configured was not established until 1947, when the General Assembly approved landmark legislation which created not only Rhode Island's sales and use tax, but also the "business corporation tax" – more commonly known as the corporate income tax.[33]

The law subjected a corporation to a tax of 3 percent on its net income.[34] For a corporation carrying on business inside and outside Rhode Island, the law established a system under which the business would apportion its net income using a three-factor formula that included its sales, property, and payroll.

What other states do

States levy various forms of business activity taxes. The most common is the corporation net income tax, which is imposed in 44 states and the District of Columbia. These taxes are similar to the federal corporate income tax, but the rates imposed are much lower, with top marginal state rates currently ranging from 3 percent to 12 percent.

Other types of business activity taxes include the Washington State business and occupation tax, Ohio commercial activity tax, Michigan business tax, and Texas "margin tax," which are general business taxes levied on gross receipts (or a variant thereof) sourced to a state, as well as the New Hampshire business enterprise tax (a value added tax).

Source: Statement of the Federation Of Tax Administrators on H.R. 2992 -- The Business Activity Tax Simplification Act Of 2013 – to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the U.S. House of Representatives, Judiciary Committee, February 26, 2014.

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30 Public Laws of Rhode Island 1912, Chapter 769.
31 Ibid. Separate taxes were established for steamboats, ferry boats, steam railroads, electric railroads, public service telegraph corporations, and a number of other businesses and industries.
32 A franchise tax still exists, under Rhode Island General Laws (RIGL) Chapter 44-12.
33 Public Laws of Rhode Island 1947, Chapter 1887.
34 For 1947 and 1948, the rate was 4 percent *or* 40 cents on each $100 of corporate excess, whichever was greater.

Overall, states that impose state corporation taxes require companies subject to those taxes to use state-specified apportionment formulas to determine income subject to tax in a taxing state.

Rhode Island corporate income tax today

Rhode Island taxes domestic and foreign[35] corporations that carry on a trade or business in Rhode Island – or that derive income from sources within Rhode Island. Rhode Island also taxes corporations that engage in transactions or activities within the state for the purpose of profit or gain.[36]

In general, a business organized as a C corporation is taxed by Rhode Island in one of two ways – under the corporate income tax itself, or under the franchise tax.[37] The business pays whichever tax is higher. (The minimum annual tax is $500, regardless of whether a C corporation suffers a loss for that year.)

Corporate income tax

Under the Rhode Island corporate income tax, the business calculates its federal taxable income on U.S. Form 1120, then carries over the federal taxable income figure to its Rhode Island Form RI-1120C.[38] The business then reduces its federal taxable income for Rhode Island purposes by applying a number of deductions – such as net operating losses (NOLs), exempt interest and dividends, and various other items.[39]

Next, the business adds back a number of items to federal taxable income for Rhode Island purposes – such as interest on other states' obligations, Rhode Island income or franchise taxes deducted on the federal return, and certain other items.

Thus, the business arrives at adjusted taxable income. The business is then ready to undertake an apportionment calculation to assign a portion of its taxable income to Rhode

[35] The term "domestic" generally means a business that is organized under Rhode Island law. The term "foreign" generally means a business that is organized under another state's laws.
[36] The Due Process and Commerce Clauses of the U.S. Constitution do not allow a state to tax income arising out of interstate activities -- even on a proportional basis -- unless there is a "minimal connection" or "nexus" between the interstate activities and the taxing state, and "a rational relationship" between the income attributed to the state and the intrastate values of the enterprise. Also, in general, Public Law 86-272 forbids a state to impose an income tax on income that is derived from within the state from interstate commerce if the only business activity within the state is the mere solicitation of orders.
[37] Businesses in Rhode Island are generally taxed under RIGL Title 44. For example, the business corporation tax is under Chapter 44-11, and a related tax -- the franchise tax -- under Chapter 44-12. However, other taxes may apply to different classes of businesses, such as the public service corporation tax, tax on banks, and tax on insurance companies.
[38] See RIGL § 44-11-1 for definition of a "corporation" that is subject to the corporate income tax, and the list of exceptions.
[39] See RIGL § 44-11-11 for the definition of "net income" as well as adjustments and other items.

Island for state tax purposes. Net income is taxed at a rate of up to 9.0 percent,[40] although the effective rate can be lower, depending on credits claimed and other factors.[41]

Franchise tax

In general, the franchise tax is equal to $2.50 per $10,000 of a corporation's authorized capital stock.[42] For corporations that have capital stock listing no par value, the deemed value by statute is $100 per share.[43]

The annual minimum tax is $500, and, like the corporate tax under RIGL Chapter 44-11, the franchise tax generally applies to every corporation, joint-stock company, or association incorporated in Rhode Island or qualified to do business in Rhode Island[44] – although certain corporations are exempt, mainly a number of hospitals and schools.[45]

Altogether, about 71 percent of C corporations pay the minimum tax of $500 each year. (Please see Table 5.)

Table 5. C corporations that pay minimum annual tax of $500

	Count	% of total
C corporations that pay minimum	10,766	71.3%
C corporations that pay more than minimum	4,341	28.7%
Total C corporations	**15,107**	**100.0%**

Source: Rhode Island Division of Taxation, tax year 2011

Business corporation tax – revenue

Overall, the corporate income tax – technically known as the business corporation tax – is projected to generate about $136 million for fiscal year 2014. (The figure includes franchise tax revenue.) Rhode Island's Revenue Estimating Conference (November 2013) projected that the business corporation tax will account for the state's sixth largest source of general revenues for fiscal 2014, just below the cigarette tax. (Please see Table 6.)

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40 RIGL § 44-11-2. (For each of a corporation's taxable years that ended on or after March 31, 1991 and before January 1, 1994, a surtax of 11 percent applied on the amount of the tax computed under RIGL § 44-11-2.)
41 A brief summary of certain key changes in Rhode Island corporate income tax law is in Appendix D.
42 RIGL § 44-12-1.
43 RIGL § 44-12-3.
44 Rhode Island Division of Taxation Regulation FT 09-01 outlines franchise tax apportionment for certain foreign corporations.
45 See RIGL § 44-12-11 for list of corporations exempt from the franchise tax provisions.

Table 6. Chief sources of Rhode Island general revenue		
Tax/receipt:	*Estimated revenue:*	*Rank:*
Personal income tax	$1,120,700,000	1
Sales and use tax	$904,000,000	2
Lottery	$394,200,000	3
Departmental receipts	$360,100,000	4
Cigarette tax	$136,300,000	5
Business corporation tax	$136,000,000	6
Source: Rhode Island Revenue Estimating Conference, November 2013, consensus estimates for fiscal year 2014, based on total general revenues of $3.427 billion.		

When only business taxes are looked at in isolation (apart from other sources of state revenue), the business corporation tax is the chief generator of state general revenues. (Please see Table 7. The figures do not include sales taxes and other levies to which businesses are also subject.)

Table 7. Rhode Island general business taxes ranked by revenue		
Tax/receipt:	*Estimated revenue:*	*Rank:*
Business corporation tax	$136,000,000	1
Insurance companies	$100,600,000	2
Public utilities gross	$95,900,000	3
Health care provider	$42,600,000	4
Financial institutions	$4,300,000	5
Bank deposits	$2,900,000	6
Source: Rhode Island Revenue Estimating Conference, November 2013, consensus estimates for fiscal year 2014, based on total general revenues of $3.427 billion.		

Other taxes on corporations

Corporations are subject to a variety of taxes in Rhode Island. They include local property taxes, sales and use taxes, excise taxes in general, state unemployment insurance taxes, the jobs development tax, and the individual income tax on business income.

Of five overall sources of state and local tax revenue for fiscal year 2010, Rhode Island's property tax generated the largest portion of the total: 45.6 percent. The corporate income tax generated the smallest portion of the total: 2.5 percent. (Please see Table 8.)

Table 8. Sources of state and local tax revenue, fiscal year 2010		
Tax type:	*Portion:*	*Rank:*
Property tax	45.6%	1
Individual income tax	18.9%	2
General sales tax	16.6%	3
Other taxes	16.4%	4
Corporate income tax	2.5%	5

"Other taxes" category includes excise taxes (such as those on alcohol, tobacco, motor vehicles, utilities, and licenses), stock transfer taxes, estate taxes.
Source: Tax Foundation's analysis of U.S. Census Bureau data

In the Tax Foundation's annual "Business Tax Climate Index" for 2014, Rhode Island ranked 46th.[46] The index is a measure of how each state's tax laws affect economic performance, according to the Tax Foundation. A rank of "1" means the state's tax system is more favorable for business; a rank of "50" means the state's tax system is less favorable for business.

The Tax Foundation ranking is compiled based on five components: the corporate tax, individual income tax, sales tax, unemployment insurance tax, and property tax. Rhode Island ranked 27th among the states for sales tax, 36th for the individual income tax, 43rd for the corporate tax, 46th for the property tax, and 50th for the state unemployment insurance tax. (Please see Table 9.)

Table 9. State business tax climate index 2014	
Tax type:	*National rank:*
Sales tax	27th
Individual income tax	36th
Corporate tax	43rd
Property tax	46th
Unemployment insurance tax	50th

A rank of "1" means the state's tax system is more favorable for business; a rank of "50" means the state's tax system is less favorable for business.
Source: Tax Foundation, 2014 State Business Tax Climate Index, based on state tax laws as of July 1, 2013, for fiscal year 2014.

Overall, Rhode Island ranked 25th among the states in fiscal 2011 for state and local corporate income tax collections per $1,000 of personal income.[47]

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[46] Tax Foundation, 2014 State Business Tax Climate Index. Snapshot date is law as of July 1, 2013.
[47] "How Rhode Island Compares," Rhode Island Public Expenditure Council, 2013 (based on RIPEC analysis of U.S. Bureau of the Census data).

Rhode Island ranked 19th among the states in fiscal 2011 for state and local corporate income tax collections per capita.[48]

Taxes on other corporations

Businesses organized as C corporations may not be subject to the business corporations or franchise tax, but may instead be taxed under other chapters of the Rhode Island General Laws.

For example, businesses categorized as "public service corporations" -- including cable, telegraph, telecommunications, gas, electric, ferry, and other corporations -- are generally taxed on their gross earnings (the tax rate depends on the industry).[49]

Banking institutions are generally taxed on their net income or their authorized capital stock. [50] Insurance companies -- including HMOs, medical malpractice insurance joint underwriters associations, nonprofit dental service corporations, and any nonprofit hospital or medical service corporation -- generally must pay an annual tax based on gross premiums.[51]

[48] Ibid.
[49] RIGL Chapter 44-13.
[50] RIGL Chapter 44-14.
[51] RIGL Chapter 44-17.

Section 3

Combined reporting

The concept of combined reporting in the United States has its roots in the 1800s, with the taxation of railroads.

In 1875, the U.S. Supreme Court was asked to determine, among other things, whether various local jurisdictions within the State of Illinois were properly taxing a railroad – taking into account the entire operation of each railroad, not just the portion of a railroad that was within a jurisdiction's particular boundaries.[52] The court ruled in favor of the taxing authorities.

> A railroad "must be regarded for many, indeed for most purposes, as a unit. The track of the road is but one track from one end of it to the other, and, except in its use as one track, is of little value. In this track as a whole each county through which [it] passes has an interest much more important than it has in the limited part of it lying within its boundary. Destroy by any means a few miles of this track within an interior county, so as to cut off the connection between the two parts thus separated, and, if it could not be repaired or replaced, its effect upon the value of the remainder of the road is out of all proportion to the mere local value of the part of it destroyed," the court said. "The theory of the system is manifestly to treat the railroad track, its rolling-stock its franchise, and its capital, as a unit for taxation, and to distribute the assessed value of this unit according as the length of the road in each county, city, and town bears to the whole length of the road," the court added. "The statute of Illinois, and the rule adopted by the board of equalization, . . . may not be the wisest mode of doing complete justice in this difficult matter; but we confess we have, on the whole, seen no scheme which is better adapted to effect the purpose, so far as railroad corporations are concerned, of taxing at once all their property, and of making the tax just and equal in its relation to other taxable property of the State."[53]

In essence, the court determined that the value of the whole was greater than the sum of the parts.[54]

[52] *State Railroad Tax Cases*, 2 AFTR 2367 (92 U.S. 575), (S Ct), 10/01/1875.
[53] Ibid.
[54] "History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?" Joe Huddleston and Shirley Sicilian, State and Local Tax Lawyer 2008 Symposium Edition.

Combined reporting and the unitary principle

The principle of combined reporting – where a corporation in one state is part of a broader enterprise, a unitary enterprise – has been developed through a number of other court cases.

For example, in the 1930s, a corporation based in Chicago, Ill. – Butler Brothers – was involved in the business of wholesale dry goods and general merchandise. It had wholesale distributing houses in seven states, including one in San Francisco, Calif. Each of its houses in the seven states maintained stocks of goods to sell to retailers, served a separate territory, had its own sales force, handled its own sales and all solicitation, credit and collection arrangements, and kept its own books.

California took the position that the San Francisco unit was part of a broader enterprise whose income should be included when calculating California tax – a position upheld by on appeal.

> "[T]his Court has recognized that unity of use and management of a business which is scattered through several States may be considered when a State attempts to impose a tax on an apportionment basis."[55]

Other cases have found similar results. For example, Edison Brothers was in the retail shoe business, operating in a number of states through a total of 15 corporations. A central management division, a central purchasing department, a central distributing department, a central store operations department, a central advertising department, and various other central administrative departments functioned in St Louis, determining operating policies and keeping the main accounting records for all of the subsidiaries.

The California corporation sold merchandise exclusively in California that it received from the parent corporation.

> "(T)he separate accounting method is appropriate to determine the true income of a separate business; but that when the business is not separate, and is an integral part of a larger . . . and unitary system, the separate accounting is inadequate and unsatisfactory in ascertaining the true result of the activities and values attributable to that business."[56]

In summary, if income arises from transactions or operations of a single economic enterprise, a state can count the entire enterprise's income – including income from out-of-state affiliates – to determine the state's share of that enterprise's income that is attributable to the state.

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[55] *Butler Brothers v. McColgan*, 17 Cal.2d 664 (1941), affirmed by U.S. Supreme Court, 315 US 501 (1942).
[56] *Edison California Stores v. McColgan*, 30 Cal.2d 472 (1947).

> "The single economic enterprise – that is, the 'unitary business' – does not necessarily correspond to a single legal entity. A unitary business could be carried out through one division of a single legal entity or through several separate, but affiliated, legal entities working together."[57]

Combined reporting in some fashion is the law in 23 states and the District of Columbia. New England states with combined reporting include Maine, Massachusetts, New Hampshire, and Vermont. (Please see Table 10.) New England states that do not have mandatory unitary combined reporting include Connecticut and Rhode Island.

Table 10. States with combined reporting

Alaska	Kansas	New York
Arizona	Maine	North Dakota
California	Massachusetts	Oregon
Colorado	Michigan	Texas
District of Columbia	Minnesota	Utah
Hawaii	Montana	Vermont
Idaho	Nebraska	West Virginia
Illinois	New Hampshire	Wisconsin

Note: New Mexico in 2013 approved mandatory unitary combined reporting for certain retailers. Sources: PricewaterhouseCoopers, January 2013; U.S. Public Interest Research Group - U.S. PIRG Education Fund - January 2014.

Combined reporting: pros and cons

Tax avoidance strategies are legal (as opposed to tax evasion, which is a crime). The principle of tax avoidance is outlined in an often-cited 1934 decision by the U.S. Court of Appeals for the Second Circuit involving Guy T. Helvering, Commissioner of Internal Revenue, and taxpayer Evelyn F. Gregory."[58]

> "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[59]

Under separate entity reporting, a corporation can legally arrange its affairs in such a way so as to limit its nexus with Rhode Island – and limit its potential exposure to the Rhode Island corporate income tax.

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[57] "History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?", Huddleston and Sicilian, *supra*.
[58] *Helvering v. Gregory*, 13 AFTR 806 (69 F.(2d) 809), (CA2), March 19, 1934.
[59] Ibid, Judge Lerned V. Hand.

One way a corporation may do this is to divide its business operations into separate segments – and incorporate each separately, in separate states (such as a separate sales unit, service unit, manufacturing unit, and research and development unit).

Example # 1.

XYZ Corp. is a retailer doing business in Rhode Island. It is affiliated with XXX Corp., which is based in Nevada and does no business in Rhode Island. XYZ Corp. in Rhode Island makes payments to its Nevada affiliate for centralized payroll, centralized administration, and certain other functions. XYZ Corp. in Rhode Island is barely profitable and pays only the Rhode Island corporate minimum tax of $500 each year. Its affiliate in Nevada, XXX Corp., is extremely profitable but pays no state income tax to Nevada because Nevada does not have a corporate income tax, and it pays no state income tax to Rhode Island because it does not have Rhode Island nexus. Under separate entity reporting, XYZ Corp. does not take into account the income of its Nevada affiliate for purposes of the Rhode Island corporate income tax.

If mandatory unitary combined reporting were the law in Rhode Island, the income of all members of an affiliated group of corporations that are part of a unitary business would be combined for purposes of the Rhode Island corporate income tax.

Example # 2.

Using the same facts and circumstances as Example # 1, but this time using mandatory unitary combined reporting, XYZ Corp. in Rhode Island would have to take into account the income of its affiliate in Nevada for purposes of the Rhode Island corporate income tax. (XYZ Corp. would continue to pay Rhode Island corporate income tax based solely on the Rhode Island share of the combined group's income, using Rhode Island's standard, equal-weighted, three-factor apportionment formula.)

Previous proposal on combined reporting

When Governor Lincoln D. Chafee in 2011 proposed combined reporting as part of broader package of tax changes for fiscal 2012,[60] the Economic Progress Institute (formerly known as the Poverty Institute), of Providence, R.I., asserted, in part, that mandating combined reporting would eliminate a legal corporate loophole that large

[60] In his budget proposal for fiscal 2012, Governor Chafee proposed to lower the $500 corporate/franchise minimum annual tax, to $250, instituting combined reporting, and phasing out the preferential rate provided under the Jobs Development Act. He also proposed to lower the corporate income tax rate over a three-year period, from 9 percent to 7.5 percent. (See "Executive Summary," Governor's Fiscal Year 2012 Budget Proposal, March 8, 2011.)

corporations use to dramatically lower their taxes by filing separate tax returns for various subsidiaries as though they were not part of the same business enterprise.[61]

> "By filing separate returns, corporations can artificially shift profits that are actually earned in Rhode Island onto the books of subsidiaries in other states in which they will be taxed at lower rates, or not taxed at all . . . The current system gives big companies an edge because they are more likely to be able to make use of tax shelters than are small firms that don't have out-of-state subsidiaries, increasing their after-tax profits and thus their ability to undercut the prices of smaller companies."[62]

The Rhode Island Public Expenditure Council (RIPEC) asserted at the time that combined reporting would represent a radical change to Rhode Island's corporate tax structure, with too many questions unanswered.[63]

> "Combined reporting represents a significant change in the structure of the state's corporate tax that heretofore has been based on the concept that every individual corporation in a multi-corporate group is taxed as a 'separate entity.' Accordingly, policymakers ought to study the proposed change to combined reporting in more depth than they would with regard to less sweeping changes in corporate tax law. As such, RIPEC would recommend that the state delay consideration of the proposed changes until there is more information on the impact of the changes. One course of action the state may want to consider is requiring a study period similar to the one required by Maryland. Entities were required to file two sets of returns, their regular corporate income tax return and a hypothetical return for entities that are part of a unitary group. The state was then able to determine the impact of combined reporting, which entities were the most likely to be affected, and expected revenues."[64]

Combined reporting positions

Proponents of combined reporting generally say that corporate tax-avoidance strategies, while legal, unfairly deprive separate-entity states such as Rhode Island of needed tax revenue. Proponents also contend that tax-avoidance strategies create an uneven playing field for businesses: Large corporations with sufficient resources can, in effect, shelter income in out-of-state affiliates, beyond the taxing power of Rhode Island; small corporations with limited resources face Rhode Island's full taxing power.

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[61] "Governor Chafee's Corporate Tax Reform: Steps in the right direction," Economic Progress Institute, April 2011.
[62] Ibid.
[63] "An Analysis of Combined Reporting," Rhode Island Public Expenditure Council, June 14, 2011.
[64] Ibid.

Proponents of combined reporting also say that it does not lead to taxation of a Rhode Island corporation's affiliates in other states. Rather, combined reporting serves only as a starting point for a state tax computation.

Combined reporting simply increases the pool of income before apportionment; only after that larger pool of income is gathered does a state's apportionment formula apply, thus ensuring that a state taxes only its fair share, proponents assert.

Opponents of mandatory combined reporting assert that it is too complicated – placing too great a burden on businesses as well as state tax agencies.

Opponents also assert that the rules for mandatory combined reporting vary by state, making the compliance burden greater on businesses. Combined reporting can also introduce greater volatility in a state's corporate tax revenue, opponents say.

COST's formal policy

The Council On State Taxation's Board of Directors has adopted a formal policy statement on mandatory unitary combined reporting:

> *"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."*
>
> -- Fred Nicely, COST Senior Tax Counsel, testimony on February 25, 2014, to Maryland House Ways and Means Committee in opposition to House Bill 887.

Among the arguments against combined reporting are those presented by the Council On State Taxation, a trade association which represents more than 600 multi-state corporations engaged in interstate and international business:[65]

- Combined reporting may increase, decrease or leave unchanged the taxable income reported on the combined return compared to the sum of the taxable incomes for the separate taxpayers, assuming that corporations in the combined group are already taxpayers in a state.

- Combined reporting has uncertain effects on a state's revenues, "making it very difficult to predict the revenue effect of adopting combined reporting." Considerable uncertainty surrounds combined reporting estimates due to the lack of needed information on separate filing returns; the inability to identify members of the unitary group; the absence of information on carryover net operating losses and unused credits into the new system; and other factors, including insufficient data to estimate changes in apportionment formulas.

[65] "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Robert Cline, Ernst & Young, May 2008 (for the Council On State Taxation).

- Combined reporting may reduce distortions in reported taxable income among related companies due to tax planning. However, combined reporting will simultaneously create new distortions related to the averaging effect for a large number of taxpayers with different profitability across businesses.

- A switch to combined reporting may have significant and unintended impacts on taxpayers and tax liabilities unrelated to tax planning.

- Proponents of combined reporting have frequently argued that combined reporting is justified by the significant percentage of corporate income taxpayers that pay no tax or pay only a state's minimum tax unrelated to corporate profits. COST says that a high percentage of companies in separate reporting states and in combined reporting states paid no corporate income taxes in excess of the minimum tax for the years reported.

- From a business taxpayer perspective, "there is a significant risk that combined reporting 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 will occur simultaneously with any gains from reducing tax planning opportunities."

Section 4

Pro forma combined reporting

If a Rhode Island corporation is a stand-alone business, with no affiliates, and does business only in Rhode Island, the corporation must file a Rhode Island income tax return and pay any tax due.

What if the Rhode Island corporation is part of a group of corporations that operate in multiple states – and all of the corporations are commonly owned and are all interdependent and integrated? In that case, the Rhode Island corporation still calculates its Rhode Island tax solely on the basis of its own books and records as a separate corporate entity.

That is because, under current law, Rhode Island requires single entity, or separate entity, reporting, not combined reporting. In other words, a C corporation doing business in Rhode Island files its return on Form RI-1120C as an individual entity, generally without regard to other entities in other states with which it is affiliated.[66]

> **Example # 3.**
>
> ABC Corp., a C corporation based in Rhode Island, is not affiliated with any other entity. It files its own Form RI-1120C.
>
> **Example # 4.**
>
> ABC Corp., a C corporation based in Rhode Island, has three affiliated corporations that are located in and operate in other states. ABC Corp. and all three affiliates are engaged in a unitary business. Under current law, ABC Corp. files its own Form RI-1120C. In general, the affiliated corporations in this example would have a Rhode Island filing requirement only if they are located in Rhode Island, are Rhode Island corporations, or have "nexus" to Rhode Island.

What if Rhode Island were to require combined reporting in Example # 4 above? The income of the Rhode Island-based corporation would be combined with the income of all other corporations in the group as a starting point for figuring out Rhode Island taxable income. The resulting pool of income would then be apportioned to Rhode Island for tax purposes.

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[66] Under Rhode Island Gen. Laws § 44-11-4, "Returns of Affiliated Groups of Corporations," an affiliated group of corporations may file a consolidated return for the taxable year in lieu of separate returns under certain circumstances. (See also Rhode Island Division of Taxation Regulation CT 88-07.)

Nexus

In general, an out-of-state corporation may be subject to Rhode Island corporate income tax if it has some type of physical presence in Rhode Island, some sort of "nexus". That is typically the case if, for example, the corporation owns or leases property in the state, or employs personnel who engage in activities in the state that exceed the level of mere solicitation of sales.

Under Rhode Island's separate entity method of reporting, the mere fact that an out-of-state corporation is affiliated with a corporation in Rhode Island is not, in itself, enough to establish a Rhode Island nexus for that out-of-state corporation.

Under separate entity reporting, a Rhode Island corporation does not have to count the income of an out-of-state affiliate as its own income for purposes of the Rhode Island corporate income tax.

The following detailed examples illustrate the tax impact of separate entity reporting versus combined reporting.

Example # 5:

The following example compares combined reporting to separate reporting for three related entities – Echo Corp., Foxtrot Corp., and Golf Corp. – that are U.S. companies, part of a unitary business, and have common ownership.[67] The example assumes that Echo Corp. is a Rhode Island retailer, Foxtrot Corp. is a Rhode Island retailer, and Golf Corp. is a Missouri retailer with no Rhode Island nexus and, therefore, no Rhode Island filing requirement but for combined reporting.[68]

Table 11. Comparison of combined reporting to separate reporting for three related entities

Apportionment:	**Echo Corp.** (Separate)	**Foxtrot Corp.** (Separate)	**Golf Corp.** (Separate)	**Combined report**
Sales Factor:				
In-state sales……………………	400	7,700	0	8,100
Everywhere sales………………	625	15,000	50,000	65,625
Sales percentage………………	64.0000%	51.3333%	0.0%	12.3429%
Property Factor:				
In-state property........................	1,000	3,000	0	4,000
Everywhere property.................	1,250	15,000	30,000	46,250
Property percentage..................	80.0000%	20.0000%	0.0%	8.6486%
Payroll Factor:				
In-state payroll...........................	500	2,000	0	2,500
Everywhere payroll....................	750	9,000	15,000	24,750
Payroll percentage....................	66.6667%	22.2222%	0.0%	10.1010%
Total weighted Apportionment percentage	70.2222%	31.1852%	0.0%	10.3642%
Taxable income total	750	9,000	75,000	84,750
In-state taxable income	527	2,807	0	8,784
Total taxable income to Rhode Island	$3,334			$8,784

Example # 6:

The following table compares combined reporting to separate reporting for two related entities – Alpha Corp. and Bravo Corp. – that are U.S. companies and members of a unitary group with common ownership and nexus in Rhode Island.

[67] Some of the examples in this section are adapted from "Combined Reporting with the Corporate Income Tax," William F. Fox and LeAnn Luna, *supra*.
[68] Most sales are in the U.S., but some are to customers in foreign jurisdictions. For purposes of apportionment calculations, the denominators reflect worldwide property, payroll and sales for businesses that are included in the combined group.

Both entities are manufacturers with manufacturing activity within Rhode Island, and elect double-weighting of sales in the apportionment formula.[69] To reflect the double-weighting of sales, the sales factor figures for Alpha and Bravo appear twice in the table below.

Table 12. Comparison of combined reporting to separate reporting for two related entities

Apportionment:	**Alpha Corp.** (Separate)	**Bravo Corp.** (Separate)	**Combined report**
Sales Factor: In-state sales...................... Everywhere sales............... Sales percentage...............	 $ 400 625 64.0000%	 $ 3,850 7,500 51.3333%	 $ 4,250 8,125 52.3077%
Sales Factor: In-state sales...................... Everywhere sales.................. Sales percentage...............	 $ 400 625 64.0000%	 $ 3,850 7,500 51.3333%	 $ 4,250 8,125 52.3077%
Property Factor: In-state property.......... Everywhere property........ Property percentage......	 1,000 1,250 80.0000%	 3,000 15,000 20.0000%	 4,000 16,250 24.6154%
Payroll Factor: In-state payroll............ Everywhere payroll......... Payroll percentage.........	 500 750 66.6667%	 2,000 9,000 22.2222%	 2,500 9,750 25.6410%
Total weighted Apportionment percentage (Double-weighted sales)	68.6667%	36.2222%	38.72%
Taxable income total	750	9,000	9,750
In-state taxable income	515	3,260	3,775
Total taxable income to Rhode Island	$3,775		$3,775

[69] RIGL § 44-11-14.6.

Determining 'combined' and 'unitary'

Regulation CT 12-15 was designed by the Division of Taxation in 2011 to set forth detailed information to help practitioners and others determine what constitutes a "combined group" for purposes of Rhode Island's *pro forma* combined reporting.

In general, a "combined group" means a group of two or more corporations in which more than 50 percent of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners – and that are engaged in a "unitary business."

Regulation CT 12-15 also set forth detailed information to help practitioners and others determine what constitutes a "unitary business." In general, a unitary business means the activities of a group of two or more corporations under common ownership that are sufficiently interdependent, integrated, or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts.

If a combined group of entities met either of two tests set forth in the regulation, the group was deemed to be a unitary business: the "interdependence of functions" test, and the "three unities" test. Both tests are adopted from several seminal court cases.[70]

Although determinations are based on the facts and circumstances of each case, the following examples illustrate the unitary principle and its interaction with combined reporting.

Example # 7:

Kilo Corp., which has its headquarters in Delaware, engages in the United States – directly and indirectly, through subsidiaries and affiliates – in the petroleum business, ranging from exploration for petroleum reserves to production, refining, transportation, and distribution and sale of petroleum and petroleum products. Its business activities in Rhode Island include the retail sale of gasoline, oil and other such products. Its business is deemed to be unitary under RIGL § 44-11-45(a)(3). *Pro forma* combined reporting was therefore required.

Example # 8:

Lima Corp. is located in Rhode Island and manufactures tin cans. A separate but related corporation is located in California and operates a sheep farm. The two corporations are under common ownership, but do not meet the tests for determining a unitary business as described in Division of Taxation Regulation

[70] *Edison California Stores v. McColgan*, 30 Cal.2d 472 (1947); *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); and *Butler Brothers v. McColgan*, 315 U.S. 501 (1942).

CT 12-15. Therefore, they are not part of a unitary business. Thus, a Rhode Island *pro forma* combined report was not needed to be filed under RIGL § 44-11-45.

Example # 9:

Mike Corp. is an Illinois corporation. Its home office is in Chicago, Illinois. It is engaged in the wholesale dry goods and general merchandise business, buying from manufacturers and others and selling to retailers only. There are separate wholesale distribution operations in seven states, including Rhode Island. Each wholesale distribution operation maintains its own stock of goods, serves a separate territory, has its own sales force, handles its own sales as well as solicitation, credit and collection arrangements, and keeps its own books of account. Each wholesale distribution operation is a separate corporation, and shares common ownership with Mike Corp. Thus, the business is deemed to be unitary under RIGL § 44-11-45(a)(3), mainly because they are in the same line of business, and *pro forma* combined reporting was therefore required.

Joyce vs. Finnigan

Once a corporation determined whether it was part of a combined group engaged in a unitary business for purposes of Rhode Island's *pro forma* combined reporting study, the corporation had to calculate the group's combined income, combined deductions, and combined additions to arrive at its adjusted taxable income – i.e., the pool of income that would be subject to tax. But Rhode Island cannot tax that entire pool of income; doing so could subject the group to tax on more than 100 percent of its income (taking into account multiple taxing jurisdictions). So the group is allowed to apportion its income, to determine which slice of the pool of income should be taxed by Rhode Island.

In performing that apportionment calculation, corporations were required by Division of Taxation regulation[71] to use two separate methods – Joyce and Finnigan – in computing the sales factor.

■ In general, the Joyce method excludes entities that do not have nexus with Rhode Island.

■ Under the Finnigan method, all sales of all members of the unitary group attributable to Rhode Island are included in the sales factor numerator.

The use of the Joyce method is implicit in the Multistate Tax Commission's model statute on combined reporting.[72]

[71] Regulation CT 12-15.
[72] "Multistate Tax Commission Proposed Model Statute for Combined Reporting," as approved by the Multistate Tax Commission on August 17, 2006, and as amended by the Multistate Tax Commission on July 29, 2011. (Please see Appendix G of this report.)

In their often-cited study on combined reporting, authors William F. Fox and LeAnn Luna summarized the differences between the Joyce and Finnigan approaches:[73]

> "In a combined report, all entities involved in the unitary business are combined for purposes of determining taxable income and the total apportionment factors. Two options, the Joyce and Finnigan approaches, exist for calculating the sales factor numerator in a unitary combined report if any individual member of the group does not have nexus with the taxing state. Under Finnigan, the group as a whole is treated as the taxpayer for apportionment purposes and all sales of members of the unitary group into the combined reporting state are included in the sales factor numerator. Under Joyce, nexus determinations are made at the level of each individual entity, and sales by an entity lacking nexus in the combined reporting state are excluded from the combined report numerator. Furthermore, tax attributes such as net operating losses and credits generated by an entity can either be available only to the entity generating the loss or credit (a Joyce approach), or to the combined group as a whole (a Finnigan approach). States may require a Finnigan approach for sales apportionment, but require a Joyce approach for other attributes, particularly net operating losses, charitable contribution carryovers, and other credits generated prior to the implementation of combined reporting."[74]

According to Fox and Luna, a majority of states with combined reporting use the Joyce approach, while 10 states use the Finnigan method.

Of the two methods, the Finnigan method costs businesses more in tax and generates the most state tax revenue.

For apportionment purposes, the Division of Taxation required corporations to perform one set of calculations using the Joyce method, another using the Finnigan method.

The following examples illustrate the difference between the Joyce and Finnigan methods for apportioning the combined income of a unitary group. For convenience, the examples use single sales factor apportionment.

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[73] See "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," William F. Fox and LeAnn Luna, *supra*.
[74] Ibid.

Example # 10:

Joyce method

Table 13. Illustration of impact of Joyce method for apportionment calculation			
Name of entity	**Rhode Island receipts**	**Everywhere receipts**	**Nexus with Rhode Island**
Hotel Corp.	50	100	Yes
India Corp.	100	200	Yes
Juliet Corp.	100	200	No
Factor total:	150	500	
Note: Joyce method includes all apportionment factor attributes in the numerator that were derived only from entities that have nexus with Rhode Island.			

Example # 11:

Finnigan method

Table 14. Illustration of impact of Finnigan method for apportionment calculation			
Name of entity	**Rhode Island receipts**	**Everywhere receipts**	**Nexus with Rhode Island**
Hotel Corp.	50	100	Yes
India Corp.	100	200	Yes
Juliet Corp.	100	200	No
Factor total:	250	500	
Note: Finnigan apportionment includes the same numerator factor attributes as Joyce, plus all Rhode Island factor attributes from entities that do not have nexus with Rhode Island.			

Pro forma combined reporting: results

Legislation enacted in 2011 required certain C corporations in Rhode Island to calculate their Rhode Island corporate income tax under existing law – and also make an extensive series of additional computations to determine what their Rhode Island corporate income tax would be under combined reporting.

> **Tax 'loopholes'**
>
> The Rhode Island General Assembly in 2007 approved a number of changes in Rhode Island corporate tax law that were generally intended to close certain corporate tax "loopholes." A summary of the changes appears in Appendix D.

The corporations were required to calculate and submit their returns in this manner for both tax year 2011 and 2012. The Division of Taxation established a special schedule, Schedule CRS, on which corporations were required to compute their *pro forma* Rhode Island corporate income tax as if combined reporting were the law.[75] The corporations attached the Schedule CRS to their regular corporate income tax return on Form RI-1120C and submitted the entire package for each tax year.

The Division of Taxation studied the results of such filings to produce this report. A summary of the results follows.

Tax Year 2011:

▪ For tax year 2011, filers showed a net *pro forma* increase of $23.4 million in tax using the Joyce method. Of the 1,370 total filers, 401 showed an increase in tax, 137 showed a decrease in tax, and 832 showed no change. (Please see Table 15.)

Table 15. *Pro forma* combined reporting: Tax Year 2011 – Joyce method (three-factor apportionment)

Increase in Tax			Decrease in Tax			No Change	Total	
Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
401	$31,033,225	$77,390	137	($7,606,284)	($55,520)	832	1,370	$23,426,941

Source: Rhode Island Division of Taxation

▪ For tax year 2011, filers showed a net *pro forma* increase of $25.3 million in tax using the Finnigan method. Of the 1,370 total filers, 420 showed an increase in tax, 130 showed a decrease in tax, and 820 showed no change. (Please see Table 16.)

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[75] A copy of Schedule CRS is included in this report, at Appendix F.

Table 16. *Pro forma* combined reporting: Tax year 2011 – Finnigan method (three-factor apportionment)											
Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
420	$32,828,692	$78,164		130	($7,543,493)	($58,027)		820		1,370	$25,285,199
Source: Rhode Island Division of Taxation											

Tax Year 2012:

▪ For tax year 2012, filers showed a net *pro forma* increase of $21.5 million in tax using the Joyce method. Of the 1,621 total filers, 343 showed an increase in tax, 125 showed a decrease in tax, and 1,153 showed no change. (Please see Table 17.)

Table 17. *Pro forma* combined reporting: Tax year 2012 – Joyce method (three-factor apportionment)											
Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
343	$27,321,476	$79,654		125	($5,811,556)	($46,492)		1,153		1,621	$21,509,920
Source: Rhode Island Division of Taxation											

▪ For tax year 2012, filers showed a net *pro forma* increase of $23.1 million in tax using the Finnigan method. Of the 1,621 total filers, 359 showed an increase in tax, 122 showed a decrease in tax, and 1,140 showed no change. (Please see Table 18.)

Table 18. *Pro forma* combined reporting: Tax year 2012 – Finnigan method (three-factor apportionment)											
Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
359	$28,916,825	$80,548		122	($5,784,150)	($47,411)		1140		1,621	$23,132,675
Source: Rhode Island Division of Taxation											

[Note: Detailed tables – including the impact of combined reporting on corporations based on federal taxable income – are included in Appendix C.]

Section 5

Other combined-reporting matters

This section of the Division of Taxation's report on *pro forma* combined reporting summarizes several key issues that are related to combined reporting, including: worldwide vs. water's edge, tax havens, the FAS 109 deduction, and consolidated returns vs. combined reports.

Worldwide vs. water's edge

For the study on *pro forma* combined reporting, the Division of Taxation asked that each combined group of corporations list its combined sales in Rhode Island and worldwide, as well as its combined income in Rhode Island and worldwide.[76]

The reason for these two additional calculations has to do with a fundamental concept which underlies combined reporting: When computing financial results for tax purposes, should a combined group of entities which is engaged in a unitary business worldwide, such as a multi-national corporation, count only the income from its business activities within the United States – in other words, only the income up to the "water's edge" – or should it also include income from its business activities in other countries?

Specifically, the term "water's edge" generally refers to the extent to which a combined group should include overseas members for purposes of combined reporting. Some states require all of a group's members worldwide to be included in the combined group. Some states allow the combined group to adopt a "water's edge" election – which generally limits a combined group's membership to members within the United States (up to the "water's edge"). The District of Columbia's general rule is for water's edge treatment, but a worldwide reporting election may be made.[77] For purposes of Rhode Island's *pro forma* combined reporting, water's edge treatment was mandatory.[78] Several key court cases support a state's right to require worldwide reporting. In one such case, the U.S. Supreme Court in 1924 determined that New York was justified in the manner in which it taxed the British brewer of Bass ale.[79]

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76 RIGL § 44-11-45(b)(1).
77 D.C. Official Code § 47-1805.02a; D.C. Municipal Regulations Rule: 9-156.
78 Under RIGL § 44-11-45(b)(3), members of a combined group had to exclude as a member and disregard the income and apportionment factors of any corporation incorporated in a foreign jurisdiction (a "foreign corporation") if the average of its property, payroll and sales factors outside the United States was 80 percent or more. (See Regulation CT 12-15 for more details.)
79 *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

> "[W]e are of opinion that, as the company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places -- the process of manufacturing resulting in no profits until it ends in sales -- the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business."[80]

Other cases have also been upheld supporting the worldwide concept. However, the federal government threw cold water on the concept in the 1980s, and states' interest in the concept waned.

A report from the U.S. Treasury Secretary in 1984, following the work of a Worldwide Unitary Taxation Working Group, said that worldwide combined reporting was unpopular with multi-national businesses and foreign governments for several reasons, including the following:[81]

- "that this method of taxation leads to state taxation of foreign source income and is at variance with the internationally accepted separate accounting method for avoiding double taxation";

- "lump[ing] together income earned in numerous profit centers throughout the world and then divid[ing] the result on a formula basis distorts the attribution of income to any particular source or state since in some centers losses are incurred, while in others profits result";

- "that distortion occurs because no deduction is allowed for foreign taxes or other payments to foreign governments"; and

- "that use of the method imposes substantial administrative burdens because of the need to translate accounts of their entire foreign operations into U.S. currency and to conform them to U.S. and state accounting rules; they note that there is no other requirement for such reporting by foreign nationals."

States that apply worldwide combined reporting include Idaho, Montana, and North Dakota.[82] There are 28 states that provide for water's edge reporting, including Alaska, Arizona, California, Colorado, Florida, Hawaii, Idaho, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Oregon, Utah, Vermont, Virginia, West Virginia, and Wisconsin.[83]

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[80] Ibid.
[81] Information on the U.S. Treasury Secretary's report, and on the Working Group, is reprinted from a draft report on combined reporting presented to a business tax reporting subcommittee in Maryland in September 2010.
[82] "State Taxation of Multinationals: Combined Reporting," Suellen Wolfe, LexisNexis Legal Newsroom: Tax Law, June 27, 2011. Note that combined reporting is mandated in some states, optional in others.
[83] Ibid.

According to a study by the State of Maryland, states with combined reporting require either worldwide or water's edge reporting as the default. Some states allow an election on timely filed returns.[84] "In order to avoid the possibility of a group shifting between water's edge and worldwide so as to minimize its tax burden, the election is typically binding for a fixed number of years."[85]

Worldwide combined reporting has also been the subject of numerous court cases, some of which have been decided by the U.S. Supreme Court. Rhode Island did not take a position on the issue when the General Assembly required a *pro forma* combined reporting study. Instead, the legislation directed that tax computations be made with a water's edge approach, but also directed the Division of Taxation to show how much in combined sales and in combined income were generated worldwide by groups of entities that were under common ownership, engaged in a unitary business, and did some of their business in Rhode Island.

However, because some corporations did not file complete *pro forma* reports involving worldwide combined reporting, and for other reasons, the Division of Taxation was not confident enough of the underlying data to present it in this report.

Tax havens

A corollary issue involves tax havens: Some states that offer a water's edge election also include statutory language requiring that a combined group of corporations engaged in a unitary business specifically include the income of affiliates operating in known tax havens.

The U.S. Public Interest Research Group's Education Fund has estimated that states that have enacted combined reporting regimes could collect an additional $1 billion in corporate tax revenue if they followed Montana and Oregon by maintaining in statute a list of tax haven jurisdictions.[86]

> "Montana and Oregon are the only states whose tax codes enumerate a list of foreign jurisdictions to be treated as tax havens for corporate tax purposes. Montana's tax havens law has been in place for more than a decade, since 2003. It requires multinational corporations making the water's-edge election to include in the unitary combined tax base the income and apportionment factors of affiliates incorporated in listed tax havens. Oregon last year adopted its new law, which took effect January 1. Alaska, West Virginia, and the District of Columbia have adopted combined reporting statutes that require the income of controlled foreign

[84] "Combined Reporting Draft," Maryland Business Tax Reporting Subcommittee, September 2, 2010.
[85] Ibid.
[86] "Consumer Group Advocates Listing Tax Havens in State Statutes," Amy Hamilton, *State Tax Today*, Tax Analysts, January 31, 2014.

> affiliates incorporated in tax havens to be included in the combined report -- but none of these states maintains its own list of tax havens directly in its code."[87]

Maine's Joint Taxation Committee on February 24, 2014, approved a bill to require corporations to include unitary members in designated tax havens when measuring taxable income; Maine Revenue Services estimated that the bill's changes would produce between $4 million and $8 million a year, based on the experiences of other states.[88]

The Council On State Taxation has said that the "branding of specific nations as 'tax havens' and thereby penalizing companies who merely do business there is bad tax policy."[89]

> "Blacklisting of specific countries is overly broad because it may result in double taxation of legitimate business activities. The blacklisting approach is by far the minority view as a means of dealing with tax avoidance strategies; in particular both California and the Multistate Tax Commission in their model legislation have rejected this approach," according to COST.[90]

Whether or not a state has combined reporting, it may still suffer a loss in potential revenue due to tax havens, according to the U.S. PIRG report. In 2011, for example, tax havens cost states about $20.7 billion in lost corporate tax revenue -- including Rhode Island, which lost out on $130 million, according to U.S. PIRG.[91]

"FAS 109" deduction

The Financial Accounting Standards Board (FASB)[92] in February 1992 issued Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." It is often referred to as FAS 109.[93] Its purpose was to establish financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years.

Under FAS 109, a corporation that is required to issue financial statements must create a liability (or an asset) for estimated taxes payable (or refundable) for the current year.

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[87] Ibid.
[88] "Maine Tax Panel Approves Tax Havens Bill," Douglas Rooks, *State Tax Today,* Tax Analysts, February 26, 2014.
[89] Statement to the Maine State Legislature, Joint Standing Committee on Taxation, in opposition to LD 1120, "An Act to Improve Maine's Tax Laws," by Ferdinand S. Hogroian, Tax & Legislative Counsel, COST, February 10, 2014.
[90] Ibid.
[91] "Closing the Billion Dollar Loophole - How States Are Reclaiming Revenue Lost to Offshore Tax Havens," U.S. Public Interest Research Group Education Fund, January 30, 2014.
[92] Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities.
[93] "FAS 109" is also known as FASB Accounting Standards Codification 740, or "ASC 740".

If combined reporting triggers an increase in a combined group's net deferred tax liability, the group may be able to claim an offsetting deduction – known generally as the FAS 109 deduction.

States handle the FAS 109 deduction in different ways. For example, the District of Columbia, where combined reporting was enacted in 2011, generally allows a FAS 109 deduction to be claimed by certain publicly held companies each year over a seven-year period -- beginning with the combined group's taxable year that begins in 2015 equal to one-seventh of the deduction amount.[94]

Massachusetts, which adopted combined reporting in 2008, also provided for a FAS 109 deduction – which was to be claimed by certain publicly held companies on a pro-rated basis over a seven-year period.[95] But Massachusetts has repeatedly delayed the implementation of the deduction, costing businesses (but saving the state) $45.9 million in annual revenue.[96]

For purposes of computing taxable income under the Rhode Island *pro forma* combined report, taxpayers were not allowed to claim a FAS 109 deduction. Instead, the Division of Taxation asked taxpayers to add a statement to their *pro forma* report and to indicate the amount of the potential deduction, as a lump sum.

For tax year 2011, which is the first year for Rhode Island's *pro forma* combined reporting study, a total of 61 corporate combined groups checked the FAS 109 box, listing a total potential lump-sum deduction of more than $1.69 billion. That works out to an average annual deduction of $242.24 million over a seven-year period – before the apportionment formula is applied. (Please see Table 19. Due to missing or incomplete data, and for other reasons, the Division of Taxation was not confident enough in the data for tax year 2012 to present it here.)

Table 19: Combined groups' *pro forma* FAS 109 deduction

Tax year	Count	Amount	Average annual deduction in aggregate over seven years
2011	61	$1,695,682,352	$242,240,336

Source: Rhode Island Division of Taxation

Thus, if Rhode Island were to adopt mandatory unitary combined reporting and allow a FAS 109 deduction, the State would have to take into account the impact of the deduction for revenue estimating purposes.

94 D.C. Municipal Regulations, Rule: 9-156.
95 Massachusetts Department of Revenue, TIR 13-15.
96 Massachusetts Governor Deval Patrick's proposed budget for fiscal year 2015, January 22, 2014.

Consolidated vs. combined

In general, combined reporting is a method of apportioning the income of corporations among the states in which they do business. Under combined reporting, members of a group of commonly owned companies that are engaged in a unitary business must report their combined income.

Combined reporting is sometimes confused with a consolidated return. As noted, combined reporting is chiefly a computation; the bulk of the work is done by the corporations before actually getting down to the filing of the return(s) – determining whether entities are engaged in a unitary business, for example, and determining which entities should be included in the combined group.

On the other hand, a consolidated return is actually a return. For federal corporate income tax purposes, an "affiliated group" -- which generally means corporations connected through stock ownership with a common parent corporation – can elect to file a single tax return, known as a consolidated return, instead of having each member of the group file its own separate return.[97]

There are potential benefits and drawbacks. For example, by filing a consolidated return, current-year operating losses incurred by one member of the group may be used to offset income of another group member. On the other hand, filing a consolidated return at the federal level is generally binding for the current year and all succeeding tax years, except in certain limited circumstances (IRS approval is typically required to switch).

Rhode Island allows an affiliated group of corporations to file a consolidated return for a given taxable year in lieu of separate returns.[98] Each member corporation of the affiliated group must be subject to taxation under RIGL Chapter 44-11, and each must have the same fiscal period. Certain other conditions must be met.[99]

Although the two subjects – "combined reporting" and "consolidated returns' – are separate, they came together, in a sense, for purposes of Rhode Island's *pro forma* combined reporting study: The Division of Taxation gave taxpayers the following guidance: In determining the members of the unitary group, the taxpayer could elect to use the same members that the taxpayer included in filing the taxpayer's federal consolidated return. Among the requirements:

■ The common parent corporation had to own, directly, stock that represented at least 80 percent of the total voting power and at least 80 percent of the total value of the stock of at least one of the other includible corporations.

■ Stock that represented at least 80 percent of the total voting power, and at least 80 percent of the total value of the stock of each of the other corporations (except for the

[97] IRC § 1501 *et seq.*
[98] RIGL § 44-11-4.
[99] See Regulation CT 88-07 for definitions and additional details.

common parent), had to be owned directly by one or more of the other includible corporations.

In other words, in place of all of the steps that would normally apply for determining members of the unitary group for purposes of filing a *pro forma* combined report for Rhode Island, the taxpayer could instead simply use all of the members of its federal affiliated group as shown on or reflected in the taxpayer's federal consolidated return.

To make the election, the taxpayer had only to check the appropriate box on Schedule CRS accompanying the Form RI-1120C – and also attach a statement detailing the election. Altogether, the consolidated return option was chosen by about 300 returns/taxpayers in each of the tax years under study. (Please see Table 20.)

Table 20: Groups electing consolidated return option

Tax year	Count
2011	329
2012	288

Source: Rhode Island Division of Taxation

Although the election was offered as a matter of convenience to taxpayers, the election was solely for purposes of *pro forma* combined reporting.

In crafting its regulation on *pro forma* combined reporting in 2011, the Division of Taxation was aware that an affiliated group of corporations making the election would probably end up taking into account fewer members than it otherwise would for purposes of Rhode Island's *pro forma* combined report.

In other words, the Division of Taxation was aware that any group making the election might well wind up showing less income -- and less tax -- on its Rhode Island *pro forma* combined report than if the election were not available.

A matter of convenience

For purposes of Rhode Island's *pro forma* combined reporting study, the Rhode Island Division of Taxation gave corporations the option to include in their combined group only those entities that were included in their affiliated group for purposes of their federal consolidated return.

The Division chose that approach solely as a matter of convenience, to encourage as many taxpayers as possible to file *pro forma* combined reports with Rhode Island. As Division of Taxation Regulation CT 12-15 put it, "Certain taxpayers may find that such an election eases the administrative and compliance burden of identifying which members to include in the combined group for Rhode Island reporting purposes."

To be included in the Rhode Island combined group required an ownership/control threshold of at least 50 percent, whereas to be included in the federal consolidated return required a threshold of at least 80 percent.

Thus, for a group taking advantage of Rhode Island's election, entities for which the ownership/control threshold was between 50 percent and 80 percent did not have to be counted for purposes of Rhode Island pro forma combined reporting.

The regulation pointed out, though, that a taxpayer would be allowed to make the election provided that those entities with which it had an ownership stake of between 50 percent and 80 percent "would not materially impact the result of the combined report were they to be included in the combined report."

In addition, the regulation made the following point: To help ensure that reports and returns were prepared in such a way so as to clearly reflect income, the Tax Administrator reserved the right to require the taxpayer to include in its Rhode Island *pro forma* combined report certain entities that were not included in the taxpayer's federal consolidated return.

Combined reporting and franchise tax

As noted in Section 2 of this report, Rhode Island corporations pay tax based on the corporate income tax or the franchise tax, whichever amount is greater.

In general, the corporate tax rate is 9 percent of net income. In general, the Rhode Island franchise tax is equal to $2.50 per $10,000 of a corporation's authorized capital stock. (For corporations that have capital stock listing no par value, the deemed value by statute is $100 per share.) The annual minimum tax is $500.

Such franchise taxes are sometimes referred to as "balance sheet taxes" – and they have been eliminated by a number of states that have enacted combined reporting.

Of the 24 jurisdictions listed by PricewaterhouseCoopers in January 2013 as requiring combined reporting, five had a balance sheet-type tax.[100]

In recent years, there has been a trend to repeal or phase out balance sheet taxes or similar alternative types of corporate taxes; several states that still impose these types of taxes have caps on the maximum amount that could be due.[101]

The Greater Boston Chamber of Commerce in January 2013 proposed phasing out the Massachusetts balance sheet tax. "This change would more closely align Massachusetts law with other states that have adopted combined reporting, and would make the state's corporate tax system more competitive with its peers," the Chamber said at the time.[102]

[100] "Making the Massachusetts Corporate Tax Code More Competitive," Greater Boston Chamber of Commerce, with economic, statistical, and technical tax expertise provided by PwC US, January 31, 2013.
[101] Ibid.
[102] Ibid.

Section 6

Apportionment

To understand the concept of single sales factor apportionment, it helps to review how a C corporation calculates its Rhode Island corporate income tax liability.

The corporation begins with its federal taxable income, then claims certain deductions (for exempt dividends and interest, for example) and makes certain additions (for depreciation allowed at the federal level but not at the Rhode Island level, for example), to arrive at its adjusted taxable income.

The corporation then must perform a calculation using a formula known as apportionment. The reason is a matter of fairness.[103] For a corporation that does business in multiple states, it would be inequitable for each state to tax all of that corporation's income – because 100 percent or more of the corporation's income could wind up being taxed by multiple states. As a result, many states allow a corporation to use a formula, known as apportionment, to approximate the income that the corporation derives from a particular state. The formula differs by state.

Rhode Island apportionment

If a corporation derives all of its income from within Rhode Island, the calculation can be straightforward – the corporation simply apportions all of its income to Rhode Island for purposes of the Rhode Island corporate income tax.[104] This is sometimes referred to as 100 percent apportionment.

But for a corporation which derives income from two or more states, the calculation is more complex. In that case, the corporation uses an apportionment formula which generally takes into account the corporation's sales, property, and payroll.[105] This is known as three-factor apportionment. Each factor is weighted equally.

■ The "property" factor generally takes into account the portion of the average net book value of a corporation's total tangible property – real estate and tangible personal property – that the corporation holds or owns in Rhode Island.

[103] The principle was affirmed by the U.S. Supreme Court in *Complete Auto Transit, Inc. v. Brady* - 430 U.S. 274 (1977).
[104] RIGL § 44-11-13.
[105] RIGL § 44-11-14.

■ The "sales" factor generally takes into account the portion of a corporation's total receipts from sales or other sources that are attributable to the corporation's activities or transactions within Rhode Island.

■ The "payroll" factor generally takes into account the portion of corporation's total wages, salaries, and other compensation paid to its employees which is attributable to services performed in connection with the corporation's activities or transactions within Rhode Island.

The corporation comes up with a ratio for each factor -- representing the portion of its property, sales, and payroll attributable to Rhode Island – and divides it by three. The resulting overall ratio is then applied to the corporation's adjusted taxable income to arrive at its apportioned Rhode Island taxable income – in other words, the amount of its taxable income to be taxed by Rhode Island.[106] That standard formula -- sometimes called three-factor apportionment[107] -- generally allows the corporation to carve up its income for state income tax purposes, thus generally avoiding the potential of having all of its income taxed by every state in which it does business.[108]

Example of Rhode Island apportionment

Assume that ABC Corp. is based in Rhode Island, where it has sales, payroll, and property. Assume, too, that the corporation has sales in another state ("State B" in the Table 21 below). ABC has $3 million in taxable income. What portion of that taxable income should be taxed to Rhode Island? Table 21 shows how Rhode Island's three-factor apportionment formula would apply in this example:

Table 21. How Rhode Island's three-factor apportionment formula may apply

	Rhode Island	State B	**Total**	Factor
Sales	$2,000,000	$2,000,000	**$4,000,000**	$2,000,000/$4,000,000 = 50%
Payroll	$1,500,000	$200,000	**$1,700,000**	$1,500,000/$1,700,000 = 88%
Property	$2,500,000	$200,000	**$2,700,000**	$2,500,000/$2,700,000 = 93%
				Sum of apportionment factors = 231%
				Sum of apportionment factors /3 = 77%

[106] After apportioning its income to Rhode Island, a corporation then makes certain adjustments (for research and development expenses, for example) to arrive at adjusted taxable income. The corporation may then figure its Rhode Island corporate income tax, at a stated rate of 9 percent. (The corporation's actual Rhode Island corporate income tax may be reduced -- by the jobs development rate reduction credit, for instance -- and/or increased by certain other items, such as credit recapture.)

[107] Rhode Island's standard three-factor apportionment formula is similar to that in the model state corporate income tax apportionment rules found in the Uniform Division of Income for Tax Purposes Act (UDIPTA), drafted in 1957 by the Uniform Law Commission. Rhode Island has not adopted UDIPTA. Also, UDIPTA is undergoing review (see, for example, "Report of the Hearing Officer: Multistate Tax Compact Article IV [UDIPTA] Proposed Amendments," Richard Pomp, October 25, 2013.)

[108] Rhode Island allows special apportionment formulas in certain cases – such as a double-weighting of the sales factor for manufacturers. More information about the special formulas is listed later in this section.

In this example, ABC Corp. divides its sales in Rhode Island ($2 million) by its total sales in all states ($4 million) to arrive at an apportionment "factor" of 50 percent. ABC Corp. performs a similar calculation involving its payroll and property factors.

The three factors total 231. That total is then divided by three to produce ABC Corp.'s overall apportionment factor for Rhode Island, 77 percent.

ABC then applies the overall apportionment factor of 77 percent to its $3 million in taxable income. In other words, according to the formula, 77 percent of ABC Corp.'s $3 million in income is taxable by Rhode Island. As a consequence, Rhode Island taxes $2,310,000 of ABC Corp.'s taxable income, at the standard rate of 9 percent. Thus, ABC Corp.'s Rhode Island corporate income tax in this example is $207,900.

The impact of the standard three-factor apportionment formula varies by corporation. But as a general rule, a corporation which has a significant physical presence in Rhode Island -- buildings, employees, and sales -- may have to pay a larger Rhode Island corporate income tax than a corporation with relatively similar taxable income whose Rhode Island income is derived largely from sales with a comparatively limited physical presence in Rhode Island (few buildings, few employees).

Rhode Island special apportionment formulas

While many corporations are subject to Rhode Island's standard three-factor apportionment formula, some corporations are allowed to use special apportionment formulas – based largely on the industry in which they operate. The special apportionment formulas are authorized by state statute.

For example, as the following page shows, regulated investment companies (RICs) are allowed to use a single factor – sales – in their apportionment calculations, disregarding property and payroll. (For more detailed information about single sales factor apportionment, please see Section 7 of this report.)

Certain corporations engaged in the manufacture of pharmaceuticals or other such medical-related items generally are able to adjust the numerator of the property and payroll factors in the apportionment formulas in a way that essentially gives them an incentive for expanding both their in-state property and payroll.

Special apportionment provisions

Rhode Island also allows corporations in certain industries to use a special apportionment formula which varies by industry. They include the following:

▪ **Certified Facility:** This provision, under RIGL § 44-11-14.1, enacted in 1992, is for a corporation with a Rhode Island facility which makes pharmaceuticals, biological products, or certain other medical-related items. Such a corporation may exclude from the numerator in the "property" factor the amount by which the net book value of qualified property in a tax year exceeds the net book value of qualified property in the preceding tax year. It also generally allows a corporation to exclude from the numerator of the "payroll" factor the amount by which total qualified payroll expenses for the tax year exceeds the total qualified payroll expenses in the immediately preceding tax year.

▪ **Regulated investment companies:** This provision, under RIGL § 44-11-14.2, enacted in 1995, is for regulated investment companies (also known as RICs, or mutual fund companies), and for securities brokerage services. It generally allows a corporation to use a single factor -- sales -- in its apportionment formula. All net income derived directly or indirectly from the sale of such services is apportioned to Rhode Island only to the extent that shareholders are domiciled in Rhode Island.

▪ **Credit card banks:** This provision, under RIGL § 44-11-14.3, enacted in 1996, is generally for financial institutions that engage only in credit card operations. It generally says that all net income derived directly or indirectly from the banking institution shall be apportioned to Rhode Island only to the extent that customers of the taxpayer are domiciled in Rhode Island.

▪ **Retirement and pension plans:** This provision, under RIGL § 44-11-14.4, enacted in 1996, is for retirement and pension plans. In general, they may elect to use a single factor -- sales -- in their apportionment formula. The special provision generally applies to any taxpayer located within Rhode Island that sells management, distribution, or administration services -- including transfer agent, fund accounting, custody and other similar or related services to or on behalf of an employee retirement plan or pension plan. It says that all such net income shall be apportioned to Rhode Island only to the extent that the beneficiaries or participants of a retirement plan or pension plan are domiciled in Rhode Island.

▪ **International investment service:** This provision, under RIGL § 44-11-14.5, enacted in 1997, is for international investment service income. Any qualified taxpayer located within Rhode Island which sells international investment management services to non-U.S. persons or non-U.S. investment funds shall exclude from its net income any income derived from the sale of international investment management services.

▪ **Manufacturers:** This provision, under RIGL § 44-11-14.6, enacted in 2003, generally says that a manufacturer may elect to use an apportionment formula which includes a double-weighted sales factor. (The manufacturer may apportion net income to Rhode Island using the following allocation fraction: 25 percent of the property factor, 25 percent of the payroll factor, and 50 percent of the sales factor.)

Apportionment in other states

Rhode Island's standard three-factor apportionment formula is similar to that in the model state corporate income tax apportionment rules found in the Uniform Division of Income for Tax Purposes Act (UDIPTA), drafted in 1957 by the Uniform Law Commission. Many states adopted UDITPA – or some variation – in the years following its drafting.

In recent years, however, a number of states have moved away from that traditional model and have established different formulas. The formulas vary by state. As of early 2014, however, the formula employed by the largest number of states uses a single factor for apportionment: sales. Altogether, more than 20 states have adopted single sales factor apportionment, some states have an apportionment formula which double-weights the sales factor, some states (including Rhode Island) employ the standard equal-weighted three-factor apportionment formula, and a few states have other apportionment formulas. (Please see Table 22.)

Table 22: Apportionment formulas by state, 2014*

Single sales factor:	Double weighted sales:	Three-factor:	Other:
California	Alabama	Alaska	Arizona
Colorado	Arkansas	Delaware	Minnesota
Georgia	Connecticut	D.C.	Ohio
Illinois	Florida	Hawaii	
Indiana	District of Columbia	Kansas	
Iowa	Idaho	Montana	
Louisiana	Kentucky	New Mexico	
Maine	Massachusetts	North Dakota	
Maryland	New Hampshire	Oklahoma	
Michigan	North Carolina	**Rhode Island**	
Minnesota	Tennessee		
Mississippi	Utah		
Missouri	Vermont		
Nebraska	Virginia		
New Jersey	West Virginia		
New York			
Oregon			
Pennsylvania			
South Carolina			
Texas			
Utah			
Wisconsin			

* Exceptions to the general rules listed may apply to certain industries and in certain situations, depending on the state. In general, formulas listed are for general manufacturing businesses; some industries have special formulas (not shown in table). "Single sales factor" = a single factor (sales) used for apportionment. "Three factor" = sales, property, and payroll, equally weighted. "Double-weighted" = three factors, with sales factor double-weighted. **Arizona**: Optional 85% apportionment formula sales factor; optional 100% to be phased in. **Connecticut**: Double-weighted sales for most businesses, single sales factor for financial service companies, manufacturers and broadcasters. **Louisiana**: Single sales factor/three-factor. **Maryland**: Single sales factor/Double-weighted sales. **Massachusetts**: Double-weighted sales/single sales factor. **New Mexico**: equal-weighted three-factor apportionment for most industries; manufacturers may elect a formula which emphasizes sales – and single sales factor election for manufacturers is being phased in. **Minnesota**: 90% sales, 5% payroll, 5% property. **New Jersey**: Single sales factor for privilege periods beginning on or after January 1, 2014. **New Mexico**: Optional single sales factor apportionment for manufacturers to be phased in. **Ohio**: Triple-weighted sales. **Oklahoma**: Allows double weighting of sales factor only if entity makes an initial investment in property or expansion of their property or facilities in Oklahoma and such initial investment cost or expansion investment cost equals or exceeds $200 million. **Utah** allows election for a taxpayer – other than a "sales factor weighted taxpayer" – to use either three-factor apportionment or a double-weighted sales factor; a "sales factor weighted taxpayer" for 2014 must use the single-weighted sales factor. **Virginia:** Double–weighted sales/single sales factor election for certain manufacturers/single sales factor mandatory for retail companies. **Washington State**: Does not have corporate income tax, but does use single sales factor for certain business activities under the business and occupation (B&O) tax. **Note**: Some states offer specialized apportionment formulas in certain circumstances not listed here.

Source: Federation of Tax Administrators; various states; other sources

Section 7

Single sales factor apportionment

When calculating what portion of their income will be taxed by Rhode Island, C corporations are required to use the standard three-factor apportionment formula, which takes into account sales, payroll, and property – and gives equal weight to each.

Some states have changed their apportionment formulas to require that apportionment calculations be made using just a single factor, sales. As noted in Table 22, more than 20 states now have single sales factor apportionment.

Single sales factor: pro and con

Broadly speaking, in-state corporations benefit from single sales factor apportionment; out-of-state corporations do not. "Corporations with relatively large shares of their nationwide property and payroll in a state adopting a sales-only formula but a relatively small share of their nationwide sales in that state receive tax cuts. Corporations with relatively little property and payroll in a state adopting a sales-only formula but significant shares of their nationwide sales in that state experience tax increases," according to the Center on Budget and Policy Priorities.[109]

Sales factor changes

Rhode Island's statute requiring a study of *pro forma* combined reporting also required taxpayers to perform calculations as if single sales factor apportionment was the law.

However, it should be noted that legislative changes to Rhode Island's apportionment formula can be made without adopting combined reporting.

For example, Rhode Island could change its standard three-factor apportionment formula to a single sales factor without adopting combined reporting.

Or, as an alternative, Rhode Island could retain its three-factor apportionment formula, but double-weight the sales factor, without adopting combined reporting.

The actual impact would vary depending on a corporation's circumstances.

For example, suppose a Rhode Island corporation has all of its property in Rhode Island, all of its payroll in Rhode Island, but sells all its products outside the state. Under current law, two-thirds of the corporation's total income might be taxed to Rhode Island; the remainder would be subject to tax in states in which its products are sold. But if Rhode Island adopted single sales factor

[109] "The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?", Michael Mazerov, Center on Budget and Policy Priorities, revised September 2005.

apportionment in this example, none of the corporation's income would be taxed to Rhode Island because none of its sales is made to Rhode Island customers. So the business would have to pay only Rhode Island's corporate minimum tax.

Suppose an out-of-state corporation has 10 percent of its sales to Rhode Island customers, but only 1 percent of its property and 1 percent of its payroll are located in Rhode Island. In that case, under three-factor apportionment, only 4 percent of its income would be taxed to Rhode Island. But under single sales factor apportionment, which looks only at sales, 10 percent of its income would be taxed to Rhode Island.[110]

Another example: A small business has all of its property, sales, and payroll in Rhode Island. In that case, all of its income is taxed to Rhode Island under the state's three-factor apportionment formula. If Rhode Island were to switch to single sales factor apportionment, all of the small business's income would continue to be taxed to Rhode Island. There would be no change.

Table 23. States with combined reporting and single sales factor apportionment

California	Michigan	Oregon
Colorado	Minnesota	Texas
Illinois	Nebraska	Utah
Maine	New York	Wisconsin

Source: U.S. PIRG Education Fund, January 2014

States that use single sales factor apportionment generally say that it reduces the corporate tax burden for a corporation with a significant in-state presence -- in property and payroll. At the same time, it generally increases the corporate tax burden on a corporation located out-of-state whose principal in-state business activity is sales.

Thus, under single sales factor apportionment, an in-state manufacturer with a large in-state footprint in buildings and staff would generally see a reduced corporate tax burden, while a large out-of-state retailer with a comparatively small physical footprint in-state – such as a chain of "big box" stores – would see an increased corporate tax burden. The following examples help to illustrate the impact of single sales factor apportionment.

Single sales factor: examples

Example # 12.

Assume that ABC Corp. is based in Rhode Island, where it has sales, payroll, and property. Assume, too, that the corporation has sales, as well as some property and payroll, in another state ("State B"). ABC has $3 million in taxable income. Using Rhode Island's standard three-factor apportionment formula, ABC calculates that 77

[110] Examples adopted from Mazerov, Ibid.

percent of its $3 million in taxable income will be taxed by Rhode Island, at the standard rate of 9 percent. Thus, ABC Corp.'s Rhode Island corporate income tax in this example will be $207,900. (Please see Table 24.)

Table 24. ABC Corp.'s Rhode Island tax under three-factor apportionment				
	Rhode Island	State B	**Total**	Factor
Sales	$2,000,000	$2,000,000	**$4,000,000**	$2,000,000/$4,000,000 = 50%
Payroll	$1,500,000	$200,000	**$1,700,000**	$1,500,000/$1,700,000 = 88%
Property	$2,500,000	$200,000	**$2,700,000**	$2,500,000/$2,700,000 = 93%
				Sum of apportionment factors = 231%
				Sum of apportionment factors /3 = 77%
Result: 77% of $3 million in income is subject to Rhode Island tax. Rhode Island tax = $207,900				

Under single sales factor apportionment, however, ABC uses only the sales factor in its apportionment calculation. Thus, in this example, 50 percent of its $3 million in taxable income is subject to Rhode Island corporate income tax, at a standard rate of 9 percent. Result: ABC Corp.'s Rhode Island corporate income tax in this example will be $135,000. (Please see Table 25.)

Table 25. ABC Corp.'s Rhode Island tax under single sales factor apportionment				
	Rhode Island	State B	**Total**	Factor
Sales	$2,000,000	$2,000,000	**$4,000,000**	$2,000,000/$4,000,000 = 50%
Payroll	n/a	n/a	n/a	n/a
Property	n/a	n/a	n/a	n/a
				Sum of apportionment factors = 50%
Result: 50% of $3 million in income is subject to Rhode Island tax. Rhode Island tax = $135,000				

In other words, under single sales factor apportionment, ABC Corp. – a Rhode Island-based corporation – pays $135,000 in Rhode Island tax, which is 35 percent less than it would pay under standard three-factor apportionment.

Example # 13.

Assume that XYZ Corp. is based in another state, where it has sales, payroll, and property. Assume, too, that XYZ has sales in Rhode Island, as well as some property and payroll. XYZ has $3 million in taxable income overall. Using standard three-factor apportionment, 23 percent of XYZ's $3 million in taxable income will be taxed by Rhode Island. XYZ's Rhode Island corporate income tax will be $62,100. (Please see Table 26.)

Table 26. How Rhode Island's three-factor apportionment formula may apply				
	Rhode Island	State B	**Total**	Factor
Sales	$2,000,000	$2,000,000	**$4,000,000**	$2,000,000/$4,000,000 = 50%
Payroll	$200,000	$1,500,000	**$1,700,000**	$200,000/$1,700,000 = 12%
Property	$200,000	$2,500,000	**$2,700,000**	$200,000/$2,700,000 = 07%
				Sum of apportionment factors = 69%
				Sum of apportionment factors /3 = 23%
Result: 23% of its $3 million in income is subject to Rhode Island tax. Rhode Island tax = $62,100				

But using single sales factor apportionment, 50 percent of XYZ's $3 million in taxable income will be taxed by Rhode Island. XYZ's Rhode Island corporate income tax will be $135,000. (Please see Table 27.)

Table 27. How Rhode Island's three-factor apportionment formula may apply				
	Rhode Island	State B	**Total**	Factor
Sales	$2,000,000	$2,000,000	**$4,000,000**	$2,000,000/$4,000,000 = 50%
Payroll	n/a	n/a	n/a	n/a
Property	n/a	n/a	n/a	n/a
				Sum of apportionment factors = 50%
Result: 50% of its $3 million in income is subject to Rhode Island tax. Rhode Island tax = $135,000				

In other words, under single sales factor apportionment, XYZ Corp. – which is based in another state – will pay more than twice the amount of Rhode Island corporate income tax than it otherwise would.

Please note that Example # 12 and Example # 13 do not include combined reporting. Also, the examples are based on a specific set of facts and circumstances; other corporations may experience different results.

Single sales factor: study results

Under RIGL § 44-11-45, corporations that were subject to *pro forma* combined reporting were asked to perform two chief calculations involving apportionment: one using the standard three-factor apportionment formula, the other using single sales factor apportionment.

In calculating apportionment, corporations also had to employ in their calculation of the sales factor both the Joyce and Finnigan methods.

Following are the results of the Division of Taxation's *pro forma* combined reporting study, in summary, when only the single sales factor was included in the apportionment calculation:

Tax Year 2011:

▪ For tax year 2011, filers showed a net *pro forma* increase of $49.5 million in tax using the Joyce method. Of the 1,370 total filers, 477 showed an increase in tax, 70 showed a decrease in tax, and 823 showed no change. (Please see Table 28.)

Table 28. ***Pro forma*** **combined reporting: Tax year 2011 – Single sales factor (Joyce)**

Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
477	$60,630,244	$127,107		70	($11,168,989)	($159,557)		823		1,370	$49,461,255

Source: Rhode Island Division of Taxation

▪ For tax year 2011, filers showed a net *pro forma* increase of $54.7 million in tax using the Finnigan method. Of the 1,370 total filers, 501 showed an increase in tax, 69 showed a decrease in tax, and 800 showed no change. (Please see Table 29.)

Table 29. ***Pro forma*** **combined reporting: Tax year 2011 – Single sales factor (Finnigan method)**

Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
501	$65,814,591	$131,366		69	($11,154,547)	($161,660)		800		1,370	$54,660,044

Source: Rhode Island Division of Taxation

Tax Year 2012:

▪ For tax year 2012, filers showed a net *pro forma* increase of $38.6 million in tax using the Joyce method. Of the 1,621 total filers, 434 showed an increase in tax, 63 showed a decrease in tax, and 1,124 showed no change. (Please see Table 30.)

Table 30. *Pro forma* combined reporting: Tax year 2012 – Single sales factor (Joyce method)

Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
434	$44,742,831	$103,094		63	($6,113,103)	($97,033)		1124		1,621	$38,629,728

Source: Rhode Island Division of Taxation

▪ For tax year 2012, filers showed a net *pro forma* increase of $44.4 million in tax using the Finnigan method. Of the 1,621 total filers, 455 showed an increase in tax, 59 showed a decrease in tax, and 1,107 showed no change. (Please see Table 31.)

Table 31. *Pro forma* combined reporting: Tax year 2012 – Single sales factor (Finnigan method)

Increase in Tax				Decrease in Tax				No Change		Total	
Count	Amount	Average		Count	Amount	Average		Count		Count	Net Change
455	$50,299,771	$110,549		59	($5,908,062)	($100,137)		1107		1,621	$44,391,709

Source: Rhode Island Division of Taxation

[Note: Detailed tables – including the impact of combined reporting and single sales factor apportionment on corporations based on federal taxable income – are included in Appendix C.]

Single sales factor: further study

There may be some interest – among policymakers and others – in the impact of single sales factor apportionment on corporations that were not subject to *pro forma* combined reporting.

RIGL § 44-11-45 did not require an analysis of the impact of single sales factor apportionment on corporations that were not subject to *pro forma* combined reporting. As a result, such an analysis is not included in this report. The Division of Taxation recognizes that such an analysis may be of interest in the future to policymakers and will provide such information to the House and Senate Finance chairs as soon as possible.

Section 8

Market-based sourcing

A study of apportionment cannot be complete without a brief discussion of market-based sourcing. Under RIGL § 44-11-45, the Division of Taxation was not asked to study the issue. Nonetheless, as more states in recent years have adopted the market-based sourcing method (as opposed to the cost-of-performance method, which applies for Rhode Island corporate income tax purposes), the Division of Taxation elected to provide a summary of the issue – mainly because the issue is tied inextricably to the determination of the sales factor in the apportionment calculation. For example, many of the states that have switched to the single sales factor method of apportionment are also using the market-based sourcing approach.

At issue, in general, is how to treat a corporation's sale of services and intangibles for purposes of corporate income tax apportionment. In general, when a corporation calculates the sales factor for apportionment purposes, it assigns the sale of its services to the state in which the income-producing activity was actually performed.[111]

What if the corporation performed activity in multiple states? In that case, the corporation assigns the sale to the state in which the corporation performed a greater proportion of the activity than in any other state – based on the cost of performance.

In general, the market-based sourcing approach says that receipts from transactions (other than sales of tangible personal property) are sourced to the market state. In other words, the sale of a corporation's services is assigned to the state in which either the services (or the benefit of the services) are received or delivered, or where the customer or marketplace is located.

Table 32. States with market-based sourcing

Alabama	Arizona	California	Georgia
Illinois	Iowa	Maine	Maryland
Massachusetts	Michigan	Minnesota	Nebraska
Ohio	Oklahoma	Utah	Washington
Wisconsin			

Source: American Bar Association, State and Local Tax Committee, May 2013.
Arizona: election for multistate service providers beginning in 2014. **Massachusetts**: adopted market-based sourcing in July 2013, effective January 1, 2014. **Nebraska**: 2014.

[111] UDIPTA, Section 17.

Example # 14

A company in Ohio provides services for a company in Illinois. All work is performed in Ohio. Under the cost-of-performance approach, Illinois would consider this an Ohio sale because the cost of performance is incurred outside of Illinois.[112]

Example # 15

A company in Ohio provides services for a company in Illinois. All work is performed in Ohio. Under the market-based sourcing approach, Illinois would consider this an Illinois sale assuming that the purchaser of the service resides in Illinois.[113]

The cost-of-performance approach was developed in 1957, when the market for goods was often in the home state, the state of origin. However, the sale of services nowadays often takes place beyond a state's borders.

A common criticism of the cost-of-performance approach is that it assigns all of the receipts from a service or from the sale of licensing of an intangible to the state that has a plurality of the costs of performing a taxpayer's income.[114]

The market-based approach essentially attributes receipts from services based on the location of the recipient of the services. However, the precise language differs from state to state. For example, some states may attribute such receipts to the state in which the customers are located, to the state in which the marketplace is located, or to the state in which the benefit of the service is received.

A number of states have jettisoned the three-factor apportionment formula in favor of increasing the weight of the sales factor, or relying solely on the sales factor. At the same time, a number of states have changed the underlying structure of the sales factor by scrapped the cost-of-performance approach and adopting market-based sourcing. "To achieve their objective of exporting the tax burden, many states concluded that they need to change the sales factor *sourcing* rules as well as the *weighting* rules, and several of them have already done so."[115]

[112] Adapted from "Trends in Multi-State Income Tax Apportionment," Mary F. Bernard, October 11, 2007, *The AICPA Tax Insider*.
[113] Ibid.
[114] "Report of the Hearing Officer: Multistate Tax Compact Article IV [UDIPTA] Proposed Amendments," Richard Pomp, October 25, 2013.
[115] "Ramifications of California's Shift to a Market-Based Sourcing Rule," J. Pat Powers and Kendall L. Houghton, *State Tax Today*, Tax Analysts, May 17, 2010.

Section 9

Process

The statute requiring a study of combined reporting is about two pages in length – and was intentionally brief. Combined reporting is so complex, and varies so widely from one state to another, the General Assembly elected to give the Division of Taxation some measure of latitude in the law's implementation -- while also ensuring that the agency understood the responsibility that came with it.

As soon as the law was enacted, on June 30, 2011, Rhode Island Tax Administrator David M. Sullivan assembled a six-member internal team at the Division of Taxation to oversee the effort of putting together a regulation on *pro forma* combined reporting to give guidance to businesses and practitioners on the implementation of the new law.

The Division of Taxation's internal team did not work in isolation. Sullivan declared that the agency's efforts should include substantial outreach in order to give stakeholders ample opportunity to provide input into the process.

Thus, the team throughout the summer of 2011 held more than a half-dozen meetings -- on-site and off-site -- with two key stakeholder groups: the Rhode Island Society of Certified Public Accountants and the Rhode Island Public Expenditure Council (RIPEC).

The CPA group provided helpful insights from the practitioner perspective, while the RIPEC group provided helpful perspective from both the business and practitioner communities.

The two groups relayed to the agency's team how *pro forma* combined reporting would affect accountants and other tax professionals and taxpayers, and how they would go about implementing the new requirement.

The two groups also offered invaluable assistance to the Division of Taxation in crafting a proposed regulation.

By October 28, 2011, after numerous revisions, the agency posted its proposed regulation -- and scheduled a public hearing on November 29, 2011.

With further input received by interested stakeholders, the Division of Taxation posted the final regulation in time to have it in place for filing season 2012, which was the first year in which pro forma combined reporting would apply.[116]

[116] Division of Taxation Regulation CT 12-15.

Combined reporting regulation

The Rhode Island Society of CPAs and RIPEC devoted countless uncompensated hours in providing invaluable assistance as the Division of Taxation set about crafting and implementing its regulation.

The regulation itself was important because it would offer what amounted to a roadmap to practitioners when attempting to comply with the law.

The agency reviewed regulations, case law, and statutes involving combined reporting from more than a dozen different states.

In addition, the Division obtained guidance from Maryland, the Federation of Tax Administrators, the Multistate Tax Commission, the Council On State Taxation, the Center on Budget and Policy Priorities, and Economic Progress Institute (formerly known as the Poverty Institute).

Furthermore, the Economic Progress Institute and Rep. Teresa A. Tanzi sat in on a number of sessions to help the Division of Taxation in developing the regulation.

The final product was 34 pages in length and included a preamble as well as numerous examples and tables to help guide practitioners in their efforts to meet the requirements of the law.

Understanding that the law was new, and to make it as convenient as possible for taxpayers to comply, the agency's regulation included three key elements:

■ a "designated agent" provision, which essentially allowed a group of companies to designate a specific individual or entity to represent the group in dealing with the Division of Taxation on matters related to combined reporting -- rather than require each entity within a group to be responsible;

■ allowing a federal consolidated group to use all of the members of its federal affiliated group for purposes of filing a *pro forma* combined report for Rhode Island -- in place of the steps that would otherwise be required for purposes of identifying which members to include in the combined group; and

■ establishing a streamlined schedule -- Schedule CRS -- specifically for *pro forma* combined reporting purposes, which a business could attach to its usual annual corporate income tax return on Form RI-1120C.

The regulation also made it clear that the *pro forma* combined reporting requirement applied only to certain business entities organized as C corporations.

A number of entities were not subject to Rhode Island's *pro forma* combined reporting requirement -- and would likely remain exempt if Rhode Island were to adopt mandatory unitary combined reporting:

- S corporations
- partnerships
- disregarded entities
- public service corporations
- state banks
- national banks
- credit unions
- insurance companies
- any corporation incorporated in a foreign jurisdiction if the average of its property, payroll, and sales factors outside the United States is 80 percent or more.

Easing compliance

The Division of Taxation made a concerted effort to ease the administrative and compliance burden on taxpayers who would be required to file *pro forma* combined reports for two successive tax years. To ensure compliance, the Division of Taxation also made the decision to liberally apply the penalty provision contained in the combined reporting statute.

The statute states that any corporation required to file a *pro forma* combined report in accordance with RIGL § 44-11-45 which failed to file a timely report or which filed a false report would be assessed a penalty not to exceed $10,000. Importantly, the Division of Taxation determined that all members of a combined group would each be assessed a separate penalty not to exceed $10,000, and that each member of the group would be jointly and severally liable for penalty. (The penalty could be waived for good cause shown for failure to timely file.)

After promulgating the regulation, the Division of Taxation held numerous off-site outreach sessions with practitioners to answer questions about *pro forma* combined reporting and provide guidance as to its implementation.

Compiling the study

Pro forma combined reporting applied to tax returns filed for tax years beginning after December 31, 2010, but before January 31, 2013.

Thus, as a practical matter, the statute applied to two consecutive tax years: 2011 and 2012. As a result, most filings involving combined reporting were received by October 15, 2012, and October 15, 2013.

Nevertheless, compiling the data proved difficult and time-consuming. One reason is the systems now in use at the Division of Taxation. The agency administers about 57 different tax/fee types and collects nearly $3 billion a year in revenue. However, to operate the state's tax system, the agency must use an assortment of hardware and software – the most critical of which was built on technology originally implemented more than 40 years ago, which is increasingly difficult and expensive operate and maintain.[117]

Data from corporate tax filings is stored on the agency's mainframe. Thus, the agency was forced to make repeated attempts to coax from its mainframe the key data which underlies this report.[118] The attempts began in the summer of 2012 and continued through February 2014.

[117] Common Business-Oriented Language, or COBOL.

[118] Legislation approved by the General Assembly and signed into law on June 15, 2012, by Governor Lincoln D. Chafee appropriated a total of $25 million over five years for the Division of Taxation to acquire and implement a new computer system, known as an integrated tax system. When fully operational, the integrated tax system will replace the agency's mainframe computer, and several other stand-alone systems, providing greater efficiency and effectiveness for the agency itself, and more opportunities for practitioners, taxpayers, and other stakeholders to interact with the agency online.

APPENDIX A: Comprehensive Example

The following comprehensive illustrates the difference between separate entity reporting and combined reporting.

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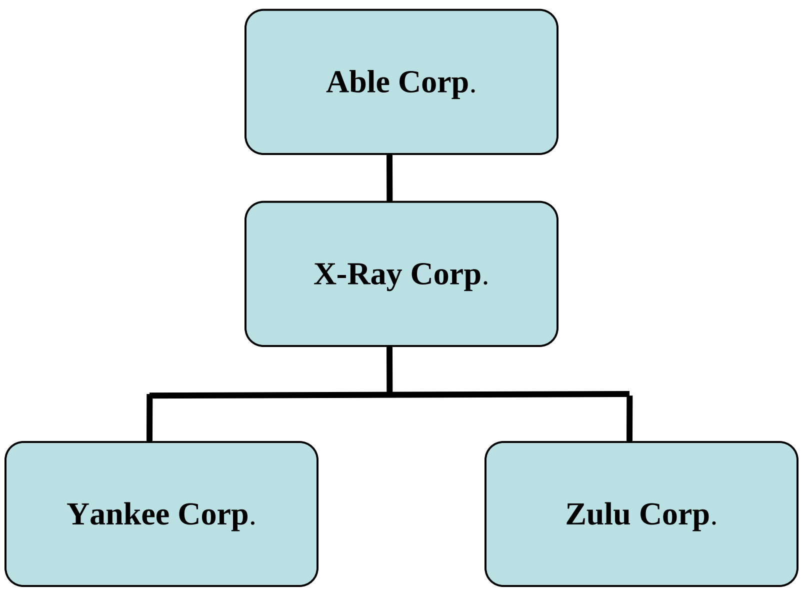
The four corporations listed below have common ownership:[119]

- X-Ray Corp. is a retailer based in Rhode Island, doing 50 percent of its business in Rhode Island.
- Yankee Corp. is a warehouse operation based in Massachusetts. It does 50 percent of its business in Rhode Island, where it has nexus and a Rhode Island filing requirement.
- Zulu Corp. is a manufacturer based in Massachusetts, has a facility in Rhode Island, and does 25 percent of its business in Rhode Island.[120]
- Able Corp., domiciled in Connecticut, is the parent company of X-Ray, which, in turn, owns Yankee and Zulu. Able does no business in Rhode Island.



Because Able Corp. has been domiciled in Connecticut, and has done no business in Rhode Island, it has not been required to file a return to Rhode Island. However, RIGL § 44-11-45 required *pro forma* combined reporting for tax years beginning after December 31, 2010, but before January 1, 2013. Under that law, and through the application of the agency's regulation, the four corporations in this example are deemed to be involved in a

[119] Common ownership is defined in Rule 5 of Regulation CT 12-15, and detailed in Rule 7.
[120] For Rhode Island apportionment purposes, Zulu Corp. chooses not to double-weight sales under RIGL § 44-11-14.6 and instead single-weights sales pursuant to RIGL § 44-11-14(a).

unitary business (due to common ownership, interdependence of functions, and certain other factors), are members of a combined group, and had to file a *pro forma* combined report.

The following table lists financial data for each of the corporations, apportionment factors on a separate entity basis, and apportionment under Rhode Island *pro forma* combined reporting. (Columns 2 through 4 are on a separate company basis. Columns 5 and 6 are informational, for use with the *pro forma* combined report. Columns 7 and 8 are combined reporting totals.)

(dollars in thousands)	**X-Ray Corp.**	**Yankee Corp.**	**Zulu Corp.**	**Able Corp.** (Joyce)	**Able Corp.** (Finnigan)	**Totals** (Joyce)	**Totals** (Finnigan)
R.I. Receipts	$ 50,000	$ 250	$ 25,000	$ 0	$ 10,000	$ 75,250	$ 85,250
Everywhere Receipts	100,000	500	100,000	250,000	250,000	450,500	450,500
Sales Factor	0.500000	0.500000	0.250000	0.000000	0.040000	0.167037	0.189234
R.I. Property	25,000	500	50,000	0	0	75,500	75,500
Everywhere Property	50,000	1,000	200,000	300,000	300,000	551,000	551,000
Property Factor	0.500000	0.5000000	0.250000	0.000000	0.000000	0.137024	0.137024
R.I. Payroll	250	250	1,000	0	0	1,500	1,500
Everywhere Payroll	500	500	4,000	25,000	25,000	30,000	30,000
Payroll Factor	0.500000	0.500000	0.250000	0.000000	0.000000	0.050000	0.050000
Total Factor	1.500000	1.500000	0.750000	0.000000	0.040000	0.354061	0.376258
R.I. Apportion. Factor	0.500000	0.500000	0.250000	0.000000	0.0133333	0.118020	0.125419

The corporations chose X-Ray Corp. to serve as their designated agent for the combined group.[121] Thus, X-Ray Corp. filed its own Form RI-1120C to Rhode Island and attached

[121] Pursuant to Rule 13(a) of Regulation CT 12-15, the designated agent had to have a Rhode Island filing requirement under RIGL chapter 44-11. Thus, Able Corp. could not be the designated agent.

the *pro forma* combined reporting schedule, Schedule CRS. Meanwhile, X-Ray, Yankee and Zulu each filed its own separate Form RI-1120C to Rhode Island. Able Corp. was not required to file its own Form RI-1120C to Rhode Island.

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> **The remainder of this comprehensive example** illustrates what the Rhode Island tax impact would be under separate entity reporting and under combined reporting.

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▪ Tax impact: Separate entity reporting

Under separate entity reporting, X-Ray, Yankee and Zulu have been filing separate returns to Rhode Island, on Form RI-1120C. Each has been reporting its own revenue, expenses and net income.

The following table shows the corporations' Rhode Island tax, calculated on a separate entity basis (*not* combined reporting). Note that X-Ray's tax is calculated at a rate of 9 percent of its $100,000 in Rhode Island adjusted taxable income, while Yankee and Zulu – both of which suffered losses – pay the minimum tax of $500 each.[122] (Able has no Rhode Island nexus, so it is not subject to Rhode Island corporate income tax.)

Tax aspects	**X-Ray Corp**	**Yankee Corp**	**Zulu Corp**
R.I. Adjusted Taxable Income	$200,000	($100,000)	($200,000)
Apportionment Factor	0.500000	0.500000	0.250000
R.I. Adjusted Taxable Income	$100,000	($50,000)	($50,000)
R.I. Tax Due	$9,000 (at 9% rate)	$500 (minimum tax)	$500 (minimum tax)
Total R.I. Tax:	$10,000		

[122] RIGL § 44-11-2(e).

[As a practical matter, the corporations in this example would have the option, as an affiliated group of corporations, to file a Rhode Island consolidated return in lieu of separate returns.[123] Assuming that they elect to file a Rhode Island consolidated return, X-Ray's $100,000 in Rhode Island adjusted taxable income would be offset by Yankee's $50,000 loss and Zulu's $50,000 loss. Thus, with consolidated Rhode Island adjusted taxable income of zero, each of the three corporations would pay the Rhode Island corporate minimum tax of $500. Able has no Rhode Island nexus, so it would not be subject to Rhode Island corporate income tax.]

▪ Tax impact: *Pro forma* combined report

The following table shows the *pro forma* tax impact of combined reporting, under both the Joyce and Finnigan methods. Note that Able's income, which was not counted under Rhode Island's separate entity reporting regime, is counted for purposes of Rhode Island *pro forma* combined reporting. Also note that, because of a lower apportionment factor, the Joyce method results in 5.9% less in Rhode Island adjusted taxable income after apportionment – and 5.9% less in Rhode Island combined tax due.

Tax items:	**Joyce method:**	**Finnigan method:**
X-Ray's Rhode Island adjusted taxable income	$ 200,000	$ 200,000
Yankee's Rhode Island adjusted taxable income	(100,000)	(100,000)
Zulu's Rhode Island adjusted taxable income	(200,000)	(200,000)
Able's Rhode Island adjusted taxable income	900,000	900,000
Combined Rhode Island adjusted taxable income	800,000	800,000
Apportionment factor	0.118020	0.125419
RI adjusted taxable income (after apportionment)	94,416	100,335
R.I. combined tax due: (at tax rate of 9%)	$ 8,497	$ 9,030

[123] RIGL § 44-11-4 and R.I. Reg. CT 88-07.

In summary, the corporations listed in this example would pay total tax of:

- $10,000 under the current separate entity system;[124]
- $8,497 under the Joyce method of combined reporting, $9,030 under Finnigan.

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[124] If they elected to file a Rhode Island consolidated return, total tax would be $1,500.

APPENDIX B: Combined reporting statute

Rhode Island Business Corporation Tax
SECTION 44-11-45

§ 44-11-45 Combined reporting study. – (a) For the purpose of this section:

(1) "Common ownership" means more than fifty percent (50%) of the voting control of each member of the group is directly or indirectly owned by a common owner or owners, either corporate or non-corporate, whether or not owner or owners are members of the combined group.

(2) "Member" means a corporation included in a unitary business.

(3) "Unitary business" means the activities of a group of two (2) or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts. The term unitary business shall be construed to the broadest extent permitted under the United States Constitution.

(4) "United States" means the fifty (50) states of the United States, the District of Columbia, the United States' territories and possessions.

(b) Combined reporting.

(1) As part of its tax return for a taxable year beginning after December 31, 2010 but before January 1, 2013, each corporation which is part of a unitary business must file a report, in a manner prescribed by the tax administrator, for the combined group containing the combined net income of the combined group. The use of a combined report does not disregard the separate identities of the members of the combined group. The report shall include, at minimum, for each taxable year the following:

(i) The difference in tax owed as a result of filing a combined report compared to the tax owed under the current filing requirements;

(ii) The difference in tax owed as a result of using the single sales factor apportionment method under this paragraph as compared to the tax owed using the current three (3) factor apportionment method under § 44-11-14;

(iii) Volume of sales in the state and worldwide; and

(iv) Taxable income in the state and worldwide.

(2) The combined reporting requirement required pursuant to this section shall not include any persons that engage in activities enumerated in §§ 44-13-4, 44-14-3, 44-14-4 or 44-17-1, whether within or outside this state. Neither the income or loss nor the apportionment factors of such a person shall be included, directly or indirectly, in the combined report.

(3) Members of a combined group shall exclude as a member and disregard the income and apportionment factors of any corporation incorporated in a foreign jurisdiction (a "foreign corporation") if the average of its property, payroll and sales factors outside the United States is eighty percent (80%) or more. If a foreign corporation is includible as a member in the combined group, to the extent that such foreign corporation's income is subject to the provisions of a federal income tax treaty, such income is not includible in the combined group net income. Such member shall also not include in the combined report any expenses or apportionment factors attributable to income that is subject to the provisions of a federal income tax treaty. For purposes of this chapter, "federal income tax treaty" means a comprehensive income tax treaty between the United States and a foreign jurisdiction, other than a foreign jurisdiction which the organization for economic co-operation and development has determined has not committed to the internationally agreed tax standard, or has committed to the international agreed tax standard but has not yet substantially implemented that standard, as identified in the then-current organization for economic co-operation and development progress report.

(c) Any corporation which is required to file a report under this section which fails to file a timely report or which files a false report shall be assessed a penalty not to exceed ten thousand dollars ($10,000). The penalty may be waived for good cause shown for failure to timely file.

(d) The tax administrator shall on or before March 15, 2014, based on the information provided in income tax returns and the data submitted under this section, submit a report to the chairpersons of the house finance committee and senate finance committee, and the house fiscal advisor and the senate fiscal advisor analyzing the policy and fiscal ramifications of changing the business corporation tax statute to a combined method of reporting.

History of Section.
(P.L. 2011, ch. 151, art. 19, § 4.)

APPENDIX C: Expanded tables

Table C-1 *below shows the results of pro forma combined reporting for tax year 2011 when using three-factor apportionment and the Joyce method in calculating the sales factor:*

Combined Reporting Study
Joyce Income Tax Method
Tax Year 2011
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	114	12,289,817	107,805	14	-52,795	(3,771)	390	518	12,237,022
$0 - $500,000	21	555,751	26,464	3	(29,620)	(9,873)	96	120	526,131
$500,000 - $1,000,000	11	147,594	13,418	2	(5,436)	(2,718)	27	40	142,158
$1,000,000 - $5,000,000	28	829,120	29,611	13	(50,754)	(3,904)	104	145	778,366
$5,000,000 - 10,000,000	22	344,519	15,660	7	(174,039)	(24,863)	50	79	170,480
$10,000,000 - $25,000,000	41	1,835,937	44,779	17	(784,875)	(46,169)	63	121	1,051,062
$25,000,000 - $100,000,000	66	2,411,419	36,537	46	(1,037,875)	(22,563)	59	171	1,373,544
$100,000,000 - $250,000,000	43	4,381,157	101,887	15	(1,019,274)	(67,952)	21	79	3,361,883
$250,000,000 - $500,000,000	27	3,523,184	130,488	11	(529,010)	(48,092)	6	44	2,994,174
$500,000,000 and Over	28	4,714,727	168,383	9	(3,922,606)	(435,845)	16	53	792,121
Total	**401**	**31,033,225**	**77,390**	**137**	**(7,606,284)**	**(55,520)**	**832**	**1,370**	**23,426,941**

Table C-2 *below shows the results of pro forma combined reporting for tax year 2011 when using three-factor apportionment and the Finnigan method in calculating the sales factor:*

Combined Reporting Study
Finnigan Income Tax Method
Tax Year 2011
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	118	13,640,757	115,600	13	(51,724)	(3,979)	387	518	13,589,033
$0 - $500,000	21	571,781	27,228	3	(29,576)	(9,859)	96	120	542,205
$500,000 - $1,000,000	12	154,703	12,892	2	(5,436)	(2,718)	26	40	149,267
$1,000,000 - $5,000,000	28	887,177	31,685	13	(52,063)	(4,005)	104	145	835,114
$5,000,000 - 10,000,000	25	374,957	14,998	6	(173,078)	(28,846)	48	79	201,879
$10,000,000 - $25,000,000	45	1,947,382	43,275	15	(782,727)	(52,182)	61	121	1,164,655
$25,000,000 - $100,000,000	67	2,420,444	36,126	46	(1,016,228)	(22,092)	58	171	1,404,216
$100,000,000 - $250,000,000	44	4,419,528	100,444	14	(991,303)	(70,807)	21	79	3,428,225
$250,000,000 - $500,000,000	30	3,675,178	122,506	9	(523,070)	(58,119)	5	44	3,152,108
$500,000,000 and Over	30	4,736,785	157,893	9	(3,918,288)	(435,365)	14	53	818,497
Total	**420**	**32,828,692**	**78,164**	**130**	**(7,543,493)**	**(58,027)**	**820**	**1,370**	**25,285,199**

__Table C-3__ below shows the results of pro forma combined reporting for tax year 2011 when using single sales factor apportionment and the Joyce method:

Combined Reporting Study
Single Sales Tax Joyce
Tax Year 2011
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	109	14,531,443	133,316	10	(66,517)	(6,652)	399	518	14,464,926
$0 - $500,000	22	801,318	36,424	3	(15,478)	(5,159)	95	120	785,840
$500,000 - $1,000,000	18	3,456,529	192,029	0		0	22	40	3,456,529
$1,000,000 - $5,000,000	44	6,028,733	137,017	9	(23,146)	(2,572)	92	145	6,005,587
$5,000,000 - 10,000,000	26	422,086	16,234	5	(158,886)	(31,777)	48	79	263,200
$10,000,000 - $25,000,000	54	2,091,174	38,725	8	(715,893)	(89,487)	59	121	1,375,281
$25,000,000 - $100,000,000	96	5,454,139	56,814	16	(1,069,299)	(66,831)	59	171	4,384,840
$100,000,000 - $250,000,000	47	3,473,766	73,910	7	(726,029)	(103,718)	25	79	2,747,737
$250,000,000 - $500,000,000	32	9,279,022	289,969	4	(286,813)	(71,703)	8	44	8,992,209
$500,000,000 and Over	29	15,092,034	520,415	8	(8,106,928)	(1,013,366)	16	53	6,985,106
Total	**477**	**60,630,244**	**127,107**	**70**	**(11,168,989)**	**(159,557)**	**823**	**1,370**	**49,461,255**

__Table C-4__ below shows the results of pro forma combined reporting for tax year 2011 when using single sales factor apportionment and the Finnigan method:

Combined Reporting Study
Single Sales Tax Finnigan
Tax Year 2011
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	119	18,536,180	155,766	7	(51,779)	(7,397)	392	518	18,484,401
$0 - $500,000	22	848,564	38,571	3	(15,324)	(5,108)	95	120	833,240
$500,000 - $1,000,000	20	3,478,767	173,938	0		0	20	40	3,478,767
$1,000,000 - $5,000,000	43	6,164,781	143,367	10	(30,386)	(3,039)	92	145	6,134,395
$5,000,000 - 10,000,000	29	516,467	17,809	4	(157,036)	(39,259)	46	79	359,431
$10,000,000 - $25,000,000	57	2,436,274	42,742	9	(750,669)	(83,408)	55	121	1,685,605
$25,000,000 - $100,000,000	100	5,301,424	53,014	16	(1,020,355)	(63,772)	55	171	4,281,069
$100,000,000 - $250,000,000	48	3,629,313	75,611	7	(712,314)	(101,759)	24	79	2,916,999
$250,000,000 - $500,000,000	32	9,730,001	304,063	5	(291,079)	(58,216)	7	44	9,438,922
$500,000,000 and Over	31	15,172,820	489,446	8	(8,125,605)	(1,015,701)	14	53	7,047,215
Total	**501**	**65,814,591**	**131,366**	**69**	**(11,154,547)**	**(161,660)**	**800**	**1,370**	**54,660,044**

***Table C-5** below shows the results of pro forma combined reporting for tax year 2012 when using three-factor apportionment and the Joyce method in calculating the sales factor:*

Combined Reporting Study
Joyce Income Tax Method
Tax Year 2012
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	77	5,289,624	68,696	1	(4,182)	(4,182)	487	565	5,285,442
$0 - $500,000	22	702,394	31,927	3	(370,334)	(123,445)	123	148	332,060
$500,000 - $1,000,000	9	154,039	17,115	8	(13,892)	(1,737)	36	53	140,147
$1,000,000 - $5,000,000	26	539,730	20,759	11	(474,985)	(43,180)	133	170	64,745
$5,000,000 - 10,000,000	17	355,903	20,935	10	(12,095)	(1,210)	77	104	343,808
$10,000,000 - $25,000,000	36	438,886	12,191	18	(137,845)	(7,658)	104	158	301,041
$25,000,000 - $100,000,000	66	4,104,278	62,186	31	(302,307)	(9,752)	118	215	3,801,971
$100,000,000 - $250,000,000	42	5,928,480	141,154	21	(1,909,958)	(90,950)	45	108	4,018,522
$250,000,000 - $500,000,000	25	2,218,940	88,758	11	(2,433,594)	(221,236)	19	55	-214,654
$500,000,000 and Over	23	7,589,202	329,965	11	(152,364)	(13,851)	11	45	7,436,838
Total	**343**	**27,321,476**	**79,654**	**125**	**(5,811,556)**	**(46,492)**	**1153**	**1,621**	**21,509,920**

***Table C-6** below shows the results of pro forma combined reporting for tax year 2012 when using three-factor apportionment and the Finnigan method in calculating the sales factor:*

Combined Reporting Study
Finnigan Income Tax Method
Tax Year 2012
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	81	5,699,254	70,361	1	(4,182)	(4,182)	483	565	5,695,072
$0 - $500,000	20	687,248	34,362	3	(369,860)	(123,287)	125	148	317,388
$500,000 - $1,000,000	10	476,886	47,689	8	(13,892)	(1,737)	35	53	462,994
$1,000,000 - $5,000,000	28	578,919	20,676	11	(474,262)	(43,115)	131	170	104,657
$5,000,000 - 10,000,000	17	419,594	24,682	10	(12,554)	(1,255)	77	104	407,040
$10,000,000 - $25,000,000	42	647,569	15,418	16	(129,217)	(8,076)	100	158	518,352
$25,000,000 - $100,000,000	68	4,355,468	64,051	31	(295,123)	(9,520)	116	215	4,060,345
$100,000,000 - $250,000,000	43	5,991,912	139,347	20	(1,906,925)	(95,346)	45	108	4,084,987
$250,000,000 - $500,000,000	26	2,353,561	90,522	11	(2,432,099)	(221,100)	18	55	-78,538
$500,000,000 and Over	24	7,706,414	321,101	11	(146,036)	(13,276)	10	45	7,560,378
Total	**359**	**28,916,825**	**80,548**	**122**	**(5,784,150)**	**(47,411)**	**1140**	**1,621**	**23,132,675**

Table C-7 *below shows the results of pro forma combined reporting for tax year 2012 when using single sales factor apportionment and the Joyce method:*

Combined Reporting Study
Single Sales Tax Joyce
Tax Year 2012
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	74	4,154,668	56,144	3	(13,616)	(4,539)	488	565	4,141,052
$0 - $500,000	29	1,138,326	39,253	2	(306,716)	(153,358)	117	148	831,610
$500,000 - $1,000,000	14	1,286,909	91,922	1	(1,384)	0	38	53	1,285,525
$1,000,000 - $5,000,000	39	5,156,870	132,227	7	(501,109)	(71,587)	124	170	4,655,761
$5,000,000 - 10,000,000	28	2,553,315	91,190	2	(1,450)	(725)	74	104	2,551,865
$10,000,000 - $25,000,000	55	1,092,710	19,867	8	(82,146)	(10,268)	95	158	1,010,564
$25,000,000 - $100,000,000	88	6,906,985	78,488	17	(315,033)	(18,531)	110	215	6,591,952
$100,000,000 - $250,000,000	53	5,466,767	103,147	8	(2,226,453)	(278,307)	47	108	3,240,314
$250,000,000 - $500,000,000	29	9,695,122	334,315	7	(2,324,146)	(332,021)	19	55	7,370,976
$500,000,000 and Over	25	7,291,159	291,646	8	(341,050)	(42,631)	12	45	6,950,109
Total	**434**	**44,742,831**	**103,094**	**63**	**(6,113,103)**	**(97,033)**	**1124**	**1,621**	**38,629,728**

Table C-8 *below shows the results of pro forma combined reporting for tax year 2012 when using single sales factor apportionment and the Finnigan method:*

Combined Reporting Study
Single Sales Tax Finnigan
Tax Year 2012
By Group Federal Taxable Income

Federal Taxable	Increase in Tax			Decrease in Tax			No Change	Total	
Income	Count	Amount	Average	Count	Amount	Average	Count	Count	Net Change
Less than $0	80	4,899,597	61,245	3	(13,616)	(4,539)	482	565	4,885,981
$0 - $500,000	28	1,140,217	40,722	2	(305,304)	(152,652)	118	148	834,913
$500,000 - $1,000,000	15	2,253,844	150,256	1	(1,384)	0	37	53	2,252,460
$1,000,000 - $5,000,000	41	5,229,043	127,538	7	(501,581)	(71,654)	122	170	4,727,462
$5,000,000 - 10,000,000	28	2,729,125	97,469	2	(1,450)	(725)	74	104	2,727,675
$10,000,000 - $25,000,000	60	1,733,281	28,888	8	(74,387)	(9,298)	90	158	1,658,894
$25,000,000 - $100,000,000	91	7,114,437	78,181	17	(253,788)	(14,929)	107	215	6,860,649
$100,000,000 - $250,000,000	54	5,723,199	105,985	7	(2,104,733)	(300,676)	47	108	3,618,466
$250,000,000 - $500,000,000	32	11,826,368	369,574	5	(2,321,414)	(464,283)	18	55	9,504,954
$500,000,000 and Over	26	7,650,660	294,256	7	(330,405)	(47,201)	12	45	7,320,255
Total	**455**	**50,299,771**	**110,549**	**59**	**(5,908,062)**	**(100,137)**	**1107**	**1,621**	**44,391,709**

APPENDIX D: Corporate tax law changes

The Rhode Island General Assembly in recent years has made a number of changes to Rhode Island's corporate income tax statutes. A summary of some of the key changes follows:[125]

- **Captive Real Estate Investment Trust Income:** The General Assembly in 2007 enacted legislation to impose a tax on the net income of captive real estate investment trusts (also known as captive REITs). Captive trusts are those not regularly traded on established securities markets where more than 50 percent of the voting power or value is owned or controlled by a single C corporation. Dividends paid by captive trusts are allowable deductions for federal tax purposes, but would be treated as net income for Rhode Island purposes.[126]

- **Intangibles Add Back:** The General Assembly in 2007 amended the corporate income tax to require corporations to add back otherwise deductible interest expenses and costs and intangible expenses and costs accrued through transactions with related companies over which they have control.[127]

- **'Throwback' Rule:** If a Rhode Island corporation does business in more than one state, the corporation typically uses a three-factor apportionment formula to determine what portion of its income will be taxed by Rhode Island. The three-factor apportionment formula takes into account a corporation's sales, payroll, and property. A ratio is calculated for each factor. However, until recently, some of a Rhode Island corporation's sales were not included in the calculation because the sales were not taxed – either because the sales were made to the federal government, or to a state where there was no tax, or to a purchaser in a state in which the corporation had no taxable nexus. (Such sales are called "nowhere sales" because they are not apportioned to any state.) In 2007, the General Assembly approved a "throwback" rule. The legislation requires Rhode Island corporations with transactions outside Rhode Island to add into the sales factor, for apportionment purposes, the gross sales from shipments made from within Rhode Island into states where the corporation is not taxable.[128] [129]

[125] Summary is adapted from "Rhode Island Revenue Facts," a publication compiled by the House Fiscal Advisory Staff, November 2009.
[126] RIGL § 44-11-1(1)(a) *et seq;* see also RIGL § 44-11-11(a).
[127] RIGL § 44-11-11(f).
[128] RIGL § 44-11-14(a)(2)(i)(B).
[129] Also in 2007, the General Assembly required that a report be prepared and submitted by December 1, 2008, "concerning the policy and fiscal ramifications of changing the corporation tax and other business income taxes to a combined method of reporting."

APPENDIX E: Observations on data

During its study of *pro forma* combined reporting, the Division of Taxation made some observations about the underlying data. Some of those observations are summarized here.

First, as noted earlier, the data is drawn from unaudited corporate tax returns. Due to the nature of the study, the Division of Taxation compiled the data based solely on the returns as filed by the corporations; there was insufficient time to audit those returns to ensure that they were complete and accurate. As a result, the Division of Taxation can give no assurance that the data in this report is 100 percent accurate or complete. There are various reasons. Following are some points to keep in mind while reviewing the underlying data for this report:

■ The Division of Taxation developed a special form – Schedule CRS – on which corporations were to include the results of *pro forma* combined reporting. The Schedule CRS was to have been included with a corporation's normal return, on Form RI-1120C. However, some taxpayers filed incomplete reports – filling in some of the Schedule CRS boxes but leaving others blank.

■ In some cases, taxpayers filed their returns with a notation to "see statement," but did not include a statement. In still other cases, tax preparation software programs did not support the filing of Schedule CRS, especially in the first year of the study. As a result, some taxpayers filed a handwritten Schedule CRS – and the data from such handwritten filings could not be entered into the agency's mainframe in time for this report.

■ If a corporation needed additional time to file given the additional burden, the agency granted a one-month extension. Upon the one-month extended due date, each corporation was to file a complete Form RI-1120C – including Schedule CRS. However, some taxpayers – it is not clear how many – filed their Form RI-1120C on time, but without a Schedule CRS; they filed their Schedule CRS a month later. In that case, the agency's mainframe computer interpreted the filing of the Schedule CRS as an amended return, and did not "pick up" the associated data. Thus, the data in each such Schedule CRS is not reflected in this report. (If the taxpayer submitted only the Schedule CRS, those reports were routed to the Corporate Tax section for review. After review, they were submitted to the Processing section, so that the data could be entered into the system. It is not clear how many returns were received in this way.)

■ On February 28, 2014, the Division of Taxation largely ended its process of tallying and vetting data for purposes of this report on *pro forma* combined reporting. However, some returns will continue to arrive at the Division of Taxation for the tax year(s) in the study – and the results of those returns are not reflected in this report. Furthermore, some of the returns that were filed in time for the study will require further revision by the Division of Taxation, while some will be amended by the taxpayers themselves. The results of such revisions and/or amendments are not reflected in this report.

■ The most often-asked question that the Division of Taxation received from practitioners regarding *pro forma* combined reporting had to do with the FAS 109 deduction. Some practitioners did not know what a FAS 109 deduction was. Some returns checked the appropriate box on Schedule CRS to indicate that a FAS 109 deduction was included in the filing as an attachment, but did not include the attachment. Some checked the Schedule CRS box involving the FAS 109 deduction, but did not list the corresponding lump-sum deduction amount.

■ Some tax preparation software programs did not support Schedule CRS for the Form RI-1120C, especially for the first taxable year of the study. As a result, some practitioners were forced to file a paper return. Some such returns were filed with a two-dimensional barcode, which allowed the return's data to be scanned into the mainframe computer system. In response, the Division of Taxation arranged with the Rhode Island Division of Information Technology to run a special mainframe query, which allowed the Division of Taxation to obtain Schedule CRS data from about 300 such 2D barcode returns.

APPENDIX F: Schedule CRS

RI-1120C page 4	Name	Federal employer identification number

Schedule CRS - Required Data for Combined Reporting Study

Section 1 - Combined Group Information

		Yes	No
A.	Is this company a member of a combined group of companies?	☐	☐
B.	Is another company the designated agent responsible for the combined group?	☐	☐
C.	If yes, provide the federal employer identification number of the designated agent filing the combined report		
D.	Is an election being made to file based on the federal consolidated return?	☐	☐
E.	Is a FAS 109 Deduction Statement attached?	☐	☐
F.	If yes, provide the lump sum FAS 109 deduction amount		

Section 2 - Combined Group Calculations

1.	Combined Federal Taxable Income		
2.	Combined Deductions (Attach detailed schedule)		
3.	Combined Additions (Attach detailed schedule)		
4.	Adjusted Taxable Income. Line 1 minus Line 2 plus Line 3		

		Rhode Island	Everywhere	Ratio
5.	Combined Average Net Book Value of Property			
6.	Combined Receipts using Joyce Method			
7.	Combined Receipts using Finnigan Method			
8.	Combined Salaries, Wages and Compensation			

		Joyce Method	Finnigan Method
9.	Combined Ratios Total: Joyce Method - Add Ratios from lines 5, 6 and 8; Finnigan Method - Add Ratios from lines 5, 7 and 8		
10.	Combined Apportionment Ratio - For each method, divide line 9 by 3.0		
11.	Rhode Island Adjusted Taxable Income - For each method, multiply line 4 times line 10		
12.	Combined Rhode Island Tax (If zero or less, enter zero.)		
13.	Credits under Combined Reporting (Attach detailed schedule)		
14.	Tax Due under Combined Reporting - Line 12 minus Line 13 (If zero or less, enter zero.)		
15.	Tax Due using Single Sales Factor (If zero or less, enter zero.)		
16.	Tax Due on actual filing (Including Rhode Island Minimum Tax for all members of the combined group)		
17.	Minimum Tax for the combined group (see instructions)		

		Rhode Island	Worldwide
18.	Combined Sales		
19.	Taxable Income		

Section 3 - Listing of Companies included in this Combined Report (If more space is needed, attach a separate sheet.)

Federal ID#	Name	2012 RI Filing Requirement (Y/N)	Federal ID#	Name	2012 RI Filing Requirement (Y/N)

Total number of companies included in this Combined Report:

APPENDIX G: MTC model statute

Multistate Tax Commission
Proposed Model Statute for Combined Reporting

As approved by the Multistate Tax Commission August 17, 2006
As amended by the Multistate Tax Commission July 29, 2011

Section 1. Definitions.

A. "Person" means any individual, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation (whether or not the corporation is, or would be if doing business in this state, subject to [state income tax act]), company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee or organization of any kind.

B. "Taxpayer" means any person subject to the tax imposed by [State Corporate income tax act].

C. "Corporation" means any corporation as defined by the laws of this state or organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be a "taxpayer." 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.

D. "Partnership" means a general or limited partnership, or organization of any kind treated as a partnership for tax purposes under the laws of this state.

E. "Internal Revenue Code" means Title 26 of the United States Code of [date] [and amendments thereto] without regard to application of federal treaties unless expressly made applicable to states of the United States.

F. "Unitary business" means [a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are 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 among them and a significant flow of value to the separate parts.] Drafter's note: This portion of the definition is drafted to follow MTC Reg. IV(b), defining a "unitary business." A state that does not wish to define unitary business in this manner should consider alternative language. In addition, this MTC Regulation defining unitary business includes a requirement of common ownership or control. A state which treats ownership or control requirements separately from the unitary business requirement will need to make additional amendments to the statutory language. Any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income. A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a partnership if the conditions of the first sentence of this section 1.F. are satisfied, to wit: there is a synergy, and exchange and flow of value between the two parts of the business and the two corporations are members of the same commonly controlled group.

G. "Combined group" means the group of all persons whose income and apportionment factors are required to be taken into account pursuant to Section 2.A. or 2.B. in determining the taxpayer's share of the net business income or loss apportionable to this State.

H. "United States" means the 50 states of the United States, the District of Columbia, and United States' territories and possessions.

I. "Tax haven" means a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and:

(i) has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
(ii) has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;
(iii) facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
(iv) explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
(v) 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.

Section 2. Combined reporting required, when; discretionary under certain circumstances.

A. Combined reporting required, when. A taxpayer engaged in a unitary business with one or more other corporations shall file a combined report which includes the income, determined under Section 3.C. of this act, and apportionment factors, determined under [provisions on apportionment factors and Section 3.B. of this act], of all corporations that are members of the unitary business, and such other information as required by the Director.

B. Combined reporting at Director's discretion, when. The Director may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of persons that are not, or would not be if doing business in this state, subject to the [State income tax Act].

In addition, if the Director determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included pursuant to Section 2.A. represents an avoidance or evasion of tax by such taxpayer, the Director may, on a case by case basis, require all or any part of the income and associated apportionment factors of such person be included in the taxpayer's combined report.

With respect to inclusion of associated apportionment factors pursuant to Section 2.B., the Director may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

Section 3. Determination of taxable income or loss using combined report.

The use of a combined report does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to this state, which shall include, in addition to other types of income, the taxpayer member's apportioned share of business income of the combined group, where business income of the combined group is calculated as a summation of the individual net business incomes of all members of the combined group. A member's net business income is determined by removing all but business income, expense and loss from that member's total income, as provided in detail below.

A. Components of income subject to tax in this state; application of tax credits and post apportionment deductions.

i. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to this state, which shall include:

(a) its share of any business income apportionable to this State of each of the combined groups of which it is a member, determined under Section 3.B.,

(b) its share of any business income apportionable to this State of a distinct business activity conducted within and without the state wholly by the taxpayer member, determined under [provisions for apportionment of business income],

(c) its income from a business conducted wholly by the taxpayer member entirely within the state,

(d) its income sourced to this state from the sale or exchange of capital or assets, and from involuntary conversions, as determined under Section 3.C.ii.(g), below,

(e) its nonbusiness income or loss allocable to this State, determined under [provisions for allocation of non-business income],

(f) its income or loss allocated or apportioned in an earlier year, required to be taken into account as state source income during the income year, other than a net operating loss, and

(g) its net operating loss carryover or carryback. If the taxable income computed pursuant to Section 3 results in a loss for a taxpayer member of the combined group, that taxpayer member has a [state] net operating loss (NOL), subject to the net operating loss limitations, carryforward and carryback provisions of [provisions on NOLs]. Such NOL is applied as a deduction in a prior or subsequent year only if that taxpayer has [State] source positive net income, whether or not the taxpayer is or was a member of a combined reporting group in the prior or subsequent year.

ii. Except where otherwise provided, no tax credit or post-apportionment deduction earned by one member of the group, but not fully used by or allowed to that member, may be used in whole or in part by another member of the group or applied in whole or in part against the total income of the combined group; and a post-apportionment deduction carried over into a subsequent year as to the member that incurred it, and available as a deduction to that member in a subsequent year, will be considered in the computation of the income of that member in the subsequent year, regardless of the composition of that income as apportioned, allocated or wholly within this state.

B. Determination of taxpayer's share of the business income of a combined group apportionable to this State.

The taxpayer's share of the business income apportionable to this State of each combined group of which it is a member shall be the product of:

i. the business income of the combined group, determined under Section 3.C., and

ii. the taxpayer member's apportionment percentage, determined under [provisions on apportionment factors], including in the [property, payroll and sales factor]numerators the taxpayer's [property, payroll and sales, respectively,] associated with the combined group's unitary business in this state, and including in the denominator the [property, payroll and sales] of all members of the combined group, including the taxpayer, which property, payroll and sales are associated with the combined group's unitary business wherever located. The [property, payroll, and sales] of a partnership shall be included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group in accordance with Section 3.C.ii.(c). and the denominator of which is the amount of the partnership's total unitary income.

C. Determination of the business income of the combined group.

The business income of a combined group is determined as follows:

i. From the total income of the combined group, determined under Section 3.C.ii., subtract any income, and add any expense or loss, other than the business income, expense or loss of the combined group.

ii. Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. The income of each member of the combined group shall be determined as follows:

(a) For any member incorporated in the United States, or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group shall be the taxable income for the corporation after making appropriate adjustments under [state tax code provisions for adjustments to taxable income].

(b) **(1)** For any member not included in Section 3.C.ii.(a), the income to be included in the total income of the combined group shall be determined as follows:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required by the [state tax code]

(D) Except as otherwise provided by regulation, the profit and loss statement of each member of the combined group, and the apportionment factors related thereto, whether United States or foreign, shall be translated into the currency in which the parent company maintains its books and records.

(E) Income apportioned to this state shall be expressed in United States dollars.

(2) In lieu of the procedures set forth in Section 3.C.ii.(b)(1), above, and subject to the determination of the Director that it reasonably approximates income as determined under [the State tax code], any member not included in Section 3.C.ii.(a) may determine its income on the basis of the consolidated profit and loss statement which includes the member and which is prepared for filing with the Securities and Exchange Commission by related corporations. If the member is not required to file with the Securities and Exchange Commission, the Director may allow the use of the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor. If above statements do not reasonably approximate income as determined under [the State tax code] the Director may accept those statements with appropriate adjustments to approximate that income.

(c) If a unitary business includes income from a partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income.

(d) All dividends paid by one to another of the members of the combined group shall, to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or an earlier year, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business which are not a part of the combined group.

(e) Except as otherwise provided by regulation, business income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 CFR 1.1502-13. Upon the occurrence of any of the following events, deferred business income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event:

(1) the object of a deferred intercompany transaction is

(A) re-sold by the buyer to an entity that is not a member of the combined group,

(B) re-sold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged, or

(C) converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged, or

(2) the buyer and seller are no longer members of the same combined group, regardless of whether the members remain unitary.

(f) A charitable expense incurred by a member of a combined group shall, to the extent allowable as a deduction pursuant to Internal Revenue Code Section 170, be subtracted first from the business income of the combined group (subject to the income limitations of that section applied to the entire business income of the group), and any remaining amount shall then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the income limitations of that section applied to the nonbusiness income of that specific member). Any charitable deduction disallowed under the foregoing rule, but allowed as a carryover deduction in a subsequent year, shall be treated as originally incurred in the subsequent year by the same member, and the rules of this section shall apply in the subsequent year in determining the allowable deduction in that year.

(g) Gain or loss from the sale or exchange of capital assets, property described by Internal Revenue Code Section 1231(a)(3), and property subject to an involuntary conversion, shall be removed from the total separate net income of each member of a combined group and shall be apportioned and allocated as follows.

(1) For each class of gain or loss (short term capital, long term capital, Internal Revenue Code Section 1231, and involuntary conversions) all members' business gain and loss for the class shall be combined (without netting between such classes), and each class of net business gain or loss separately apportioned to each member using the member's apportionment percentage determined under Section 3.B., above.

(2) Each taxpayer member shall then net its apportioned business gain or loss for all classes, including any such apportioned business gain and loss from other combined groups, against the taxpayer member's nonbusiness gain and loss for all classes allocated to this State, using the rules of Internal Revenue Code Sections 1231 and 1222, without regard to any of the taxpayer member's gains or losses from the sale or exchange of capital assets, Section 1231 property, and involuntary conversions which are nonbusiness items allocated to another state.

(3) Any resulting state source income (or loss, if the loss is not subject to the limitations of Internal Revenue Code Section 1211) of a taxpayer member produced by the application of the preceding subsections shall then be applied to all other state source income or loss of that member.

(4) Any resulting state source loss of a member that is subject to the limitations of Section 1211 shall be carried forward [or carried back] by that member, and shall be treated as state source short-term capital loss incurred by that member for the year for which the carryover [or carryback] applies.

(h) Any expense of one member of the unitary group which is directly or indirectly attributable to the nonbusiness or exempt income of another member of the unitary group shall be allocated to that other member as corresponding nonbusiness or exempt expense, as appropriate.

Section 4. Designation of surety.

As a filing convenience, and without changing the respective liability of the group members, members of a combined reporting group may annually elect to designate one taxpayer member of the combined group to file a single return in the form and manner prescribed by the department, in lieu of filing their own respective returns, provided that the taxpayer designated to file the single return consents to act as surety with respect to the tax liability of all other taxpayers properly included in the combined report, and agrees to act as agent on behalf of those taxpayers for the year of the election for tax matters relating to the combined report for that year. If for any reason the surety is unwilling or unable to perform its responsibilities, tax liability may be assessed against the taxpayer members.

Section 5. Water's-edge election; initiation and withdrawal.

A. Water's-edge election.

Taxpayer members of a unitary group that meet the requirements of Section 5.B. may elect to determine each of their apportioned shares of the net business income or loss of the combined group pursuant to a water's-edge election. Under such election, taxpayer members shall take into account all or a portion of the income and apportionment factors of only the following members otherwise included in the combined group pursuant to Section 2, as described below:

i. the entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

ii. the entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is 20 percent or more;

iii. the entire income and apportionment factors of any member which is a domestic international sales corporations as described in Internal Revenue Code Sections 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code Sections 921 to 927, inclusive; or any member which is an export trade corporation, as described in Internal Revenue Code Sections 970 to 971, inclusive;

iv. any member not described in [Section 5.A.i.] to [Section 5.A.iii.], inclusive, shall include the portion of its income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto;

v. any member that is a "controlled foreign corporation," as defined in Internal Revenue Code Section 957, to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation shall be excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

vi. any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto; and

vii. the entire income and apportionment factors of any member that is doing business in a tax haven, where "doing business in a tax haven" is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I., the activity of the member shall be treated as not having been conducted in a tax haven.

B. Initiation and withdrawal of election

i. A water's-edge election is effective only if made on a timely-filed, original return for a tax year by every member of the unitary business subject to tax under [state income tax code]. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of a water's-edge election, including termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change.

ii. Such election shall constitute consent to the reasonable production of documents and taking of depositions in accordance with [state statute on discovery].

iii. In the discretion of the Director, a water's-edge election may be disregarded in part or in whole, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in the combined report without regard to the provisions of this section, if any member of the unitary group fails to comply with any provision of [this act] or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax.

iv. A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstituted after withdrawal, prior to the expiration of the 10 year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10 year period, a taxpayer may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election shall be in place for an additional 10 year period, subject to the same conditions as applied to the original election.