

**SENATE BILL 749
AND UNITARY COMBINED REPORTING:**

**A CRITICAL ANALYSIS
AND
RECOMMENDATIONS FOR CHANGE**



**Prepared by the Tax Committee
of the
West Virginia Chamber of Commerce**

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TERMS AND ACRONYMS

BFT – West Virginia Business Franchise Tax (Code §11-23-1 *et seq.*)

CNIT – West Virginia Corporation Net Income Tax (Code §11-24-1 *et seq.*)

COST – Council on State Taxation

EOC – West Virginia Economic Opportunity Credit (Code §11-13Q-1 *et seq.*)

GAAP – Generally Accepted Accounting Principles

IRC – Federal Internal Revenue Code

MTC – Multistate Tax Commission

NAIC – National Association of Insurance Commissioners

NOL – Net Operating Loss

Post-SB 749 – State law in effect on and after December 31, 2008 as a result of Senate Bill 749

Pre-SB 749 – State law in effect prior to January 1, 2009

SB 749 – Enrolled Senate Bill 749 (2007 Regular Session)

UDITPA – Uniform Division of Income for Tax Purposes Act

WVCSR – West Virginia Code of State Regulations

PREFACE

In the waning hours of its 2007 Regular Session, the West Virginia Legislature enacted Senate Bill 749 (SB 749)¹ that provides for a significant and much needed reduction in the Business Franchise Tax (BFT). The Chamber lauds this action as a step towards spurring economic development and making the state more competitive with its neighboring states and the rest of the nation.

However, in addition to the BFT tax reduction, SB 749 contains other provisions that will significantly change the way that the income of corporations operating inside and outside of West Virginia is taxed. Given the last-minute enactment of **mandatory unitary combined reporting** requirements, the complexity of the issues involved and the uncertainty of their impact upon the state and taxpayers, legislative and Administration leaders chose to delay the effective date of the bill's provisions until 2009 so that interested and affected parties could have the opportunity to review the new law and offer feedback and recommendations for change.

To that end, this document is a critical analysis of unitary combined reporting and the provisions of SB 749 by the West Virginia Chamber of Commerce. It is offered in the spirit of seeking a realistic and fair method of determining the proper amount of income tax that should be due and owing the state.

This analysis--along with recommendations for change--was developed by the Tax Committee of the Chamber. Special acknowledgement and thanks are given to committee members who were the principle contributors to this document:

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NOTE: References herein to, for example, §11-24-1 are to sections of the West Virginia Code unless otherwise provided. Also, unless otherwise provided (such as indicating emphasis added), strike-throughs indicate language that would be deleted from a Code provision and underscoring indicates language that would be added.

¹ Appendix A is an excerpt of the provisions of SB 749 that implement mandatory unitary combined reporting as contained in the House Floor amendment of March 10, 2007.

EXECUTIVE SUMMARY

The last-minute passage of mandatory unitary combined reporting requirements in Senate Bill 749 (2007) will significantly change the way that the income of corporations operating inside and outside of West Virginia is taxed. Unitary combined reporting is a method of taxing the income of certain groups of affiliated corporations that operate in more than one state and/or nation. In essence, it disregards the fact that members of such groups are separate legal entities if they, together, are operating a unitary business enterprise.

Opponents of mandatory unitary combined reporting--consisting mostly of large multi-state and multi-national corporations--maintain that it allows a state to improperly tax income earned in other states and nations. Proponents of mandatory unitary combined reporting maintain that it better reflects the economic reality of integrated business enterprises and prevents abuses of separate reporting which, they say, is used to distort the taxable income earned in a particular state. Experience and a review of recent literature suggests that multi-state and multi-national businesses will perceive the state's adoption of mandatory unitary combined reporting as represented in SB 749 as a negative for doing business in West Virginia.

The question of what constitutes unitary business activity in the case of multi-state/multi-national companies--particularly diversified conglomerates--rarely has a simple answer. Unfortunately, it is also a question with which West Virginia tax administrators have little experience. Moreover, the current or expected capacity of the State Tax Department to have sufficient numbers of trained auditors to examine the records of such taxpayers, in order to apply the unitary business rules, is seriously in doubt. The Department will need taxpayer service representatives, internal auditors, lawyers and field auditors who are all trained to administer forced world-wide combination reporting, the water's-edge election, and the difficult concept of unitary business.

The Chamber applauds the delay in the implementation of the combined reporting provisions of SB 749 until January 1, 2009 so that state leaders and taxpayers may examine them and the uncertain impacts upon economic development and state tax revenues. It is in that light and spirit that the Chamber presents the following recommendations:

► **Governor Manchin and the Legislature should give serious consideration to New York's *quasi-discretionary combined reporting* approach, or *add-back of certain expenses* as envisioned in HB 4670 (2004), as a substitute to the mandatory combined reporting structure enacted in SB 749. In any case, the option to file a West Virginia consolidated return when a federal consolidated return is filed should be retained and be in lieu of any requirement to file a combined report.**

► **However, if state leaders and policymakers are so inclined as to retain the SB 749 mandatory unitary combined reporting structure, a number of changes must be considered:**

- **Except for motor carriers, a single apportionment factor--sales--should replace the three-factor apportionment of sales, property and payroll.**

- The “throw out” rule in SB 749 should be repealed and it should not be replaced by a “throwback” rule.
- Financial institutions should not be penalized for having West Virginia as their domicile. Taxes should be derived from financial institutions based solely on their financial activity, irrespective as to their state of domiciliary.
- The nexus standards of pre-SB 749 law should be retained for non-domiciled financial institutions.
- The single-factor apportionment provisions of pre-SB 749 law should be retained for financial institutions.
- SB 749 should be clarified to indicate that, if the “throw out” provisions are not repealed, they shall not apply to revenues generated by financial institutions outside of West Virginia.
- The pre-SB 749 special apportionment rules with respect to motor carriers should be retained.
- The treatment of corporate partnerships should not depend upon whether the partnership is engaged in unitary business activity. Conflicts between provisions of SB 749 in this regard need to be addressed.
- All members of a unitary group should be able to utilize the full amount of tax credits earned by a member of the group.
- All insurance companies should be excluded from the CNIT, excluded from the West Virginia combined report, and excluded from a West Virginia combined return.
- Allow the use of consolidated net operating loss (NOL) carry-forwards against the tax liability of any member of a unitary combined group of taxpayers which was included in the filing of the consolidated return during the year that the West Virginia consolidated NOL’s were incurred.
- §11-24-13e (designation of surety) should be rewritten to make it a viable option for corporations; otherwise, it should be repealed.
- The combined group, for purposes of filing a West Virginia combined return, should include only the affiliated group of corporations as defined for purposes of filing a consolidated federal income tax return, with such increasing and decreasing modifications to their business income as are required to arrive at a true water’s-edge determination of West Virginia combined taxable income and apportionment factors.

- **If the Chamber’s recommendation is accepted that SB 749 be amended to limit the combined group for West Virginia filing purposes to the affiliated group of corporations, as defined for purposes of filing a consolidated federal income tax return, the “tax haven” definition contained in §11-24-3a(25) should also be eliminated.**

I. OVERVIEW

A. Legislative History

Late in the Legislature's 2007 Regular Session, a group of Senators lead by Brooks McCabe (Kanawha County) and Finance Committee Chairman Walt Helmick (Pocahontas County), introduced and obtained Senate passage of a trio of bills that would have: (1) phased down the Corporation Net Income Tax (CNIT) rate from 8.75% to 6.5% in three annual steps (SB 750); (2) phased out the Business Franchise Tax (BFT) by annually reducing its rate over six years (SB 751); and (3) required unitary combined reporting of the income of multi-corporate groups engaged in a unitary business inside and outside of West Virginia for purposes of the CNIT and BFT (SB 749). The first two proposals would have implemented major, long-term business tax relief initiatives that were recommended as a part of Governor Manchin's 2006 Tax Modernization Project, but not expressly addressed in the Governor's 2007 legislative agenda. The third proposal was seen as a way to improve both fairness and corporation income tax revenue collections.

In the House of Delegates, no action was taken on the CNIT rate reductions, but a compromise bill--SB 749--was approved in the final hours of the session, whereby the BFT would be phased down from 0.55% to 0.20% over five years, and unitary combined reporting would be required under both the CNIT and BFT. However, the version of combined reporting adopted by the House, at the urging of the Administration, not only greatly strengthened the government's hand in enforcing combined reporting, but, unlike the original Senate version, repealed the special rules for taxation of banks that had been in the law since the early 1990s. The Senate quickly adopted the House amendments and SB 749 was passed, and later signed by the Governor.

Due to the suddenness and radical nature of the changes in the final version of SB 749, its effective date was pushed back to January 1, 2009, and both legislative leaders and Administration officials have actively invited input from affected taxpayers for suggestions to refine and improve the legislation before it actually takes effect.

B. Background of Unitary Combined Reporting

Unitary combined reporting is a method of taxing the income of certain groups of affiliated corporations that operate in more than one state and/or nation. In essence, it disregards the fact that members of such groups are separate legal entities if they, together, are operating a unitary business enterprise. In such circumstances, those corporate affiliates are required to file a single report of their combined income for state income tax return purposes. The business income of the group, as so determined, is then apportioned to each member using the member's numerators of the state apportionment formula and the group's aggregate denominators. Each member of the group having nexus with the taxing state is required to report its portion of the group's business income on its return filed with the taxing authority, unless the law allows or requires the filing of a combined return. Even if a combined return is filed, each member of the combined group with taxable nexus in the taxing state is required to file a separate return reporting its non-business income allocated to the taxing state and its business income from non-unitary business activity, apportioned to the taxing state.

This approach is to be contrasted with the long-standing rule in West Virginia and the majority of states (including all of our surrounding states) that gives those corporations the option of filing together as a consolidated group or filing separate returns reflecting only the filing corporation's separate income. In either case, the income, whether reported on a combined or separate basis, is typically apportioned to the taxing state based on the portion of the three factors of its sales, property and payroll that the taxpayer or the group, as the case may be, has inside the state.

Most states do not allow the filing of a consolidated return, and some that do only permit those members of the federal consolidated group with taxable nexus in the state to be included in the consolidated state return, e.g. Alabama and Arkansas. Other states, such as Maryland and Pennsylvania, do not permit the filing of a consolidated return. These states are known as the separate entity states. In Kentucky, the filing of a consolidated return is elective and all members included in the consolidated federal return are required to be included in the consolidated Kentucky return. In Ohio, a consolidated income tax return can be filed with the prior written approval of the Tax Commissioner. In Virginia, corporations may elect to file a separate, combined or consolidated return, and the election may not be changed without the consent of the Tax Commissioner.

NOTE: There is a difference between a combined *report* and a combined *return*. Under SB 749, corporations engaged in unitary business activity are required to file a combined report in which the adjusted federal taxable business income for the group is determined. This number is then apportioned among the members included in the report using the group's denominator of the property, payroll and sales factors and each member's West Virginia numerator. Each member doing business in West Virginia is required to file its own return reporting its non-business income allocated to West Virginia, its unitary business income apportioned to West Virginia and its non unitary business income apportioned to West Virginia, unless the unitary group elects to file a combined return reporting the group's business income apportioned to West Virginia. Each member of the unitary business that is doing business in West Virginia is also required to file a separate return reporting its non-business income allocated to West Virginia and its business income from non unitary business activity apportioned to West Virginia. It is uncertain whether these items can be reported on the group's combined return.

A West Virginia consolidated return may be filed only when the affiliated group files a federal consolidated return for the year. The consolidated return must include all members included in the federal consolidated return. Federal law specifies the members for the affiliated group that must be included in the federal consolidated return. Only companies at least 80 percent owned by a common parent may be included in the federal consolidated return. In contrast, the unitary group includes any company controlled by a member of the unitary group that is engaged in unitary business activity. "Controlled" is not defined in SB 749. It at least includes any corporation that is more than 50 percent owned by another corporation when engaged in unitary business activity. However, there are circumstances in which a one corporation can control another corporation but not own a majority of the corporation's stock.

For many years, the unitary combined reporting requirement has been most prevalent in the western states of the U.S., most of which are typically long-time members of the Multi-State Tax Commission (MTC). The opponents of mandatory unitary combined reporting, consisting mostly

of large multi-state and multi-national corporations, maintain that it allows a state to improperly tax income earned in other states and nations. Its proponents (currently led by Michael Mazerov of the Center on Budget and Policy Priorities, Washington, DC²) maintain that it better reflects the economic reality of integrated business enterprises and prevents abuses of separate reporting which, they say, is used to distort the taxable income earned in a particular state. Mazerov expounded on his position on December 11, 2006 before Subcommittee B of the Legislature's Joint Committee on Finance.

Specifically, multi-state corporate groups have been known to establish separate subsidiaries in low (or 0%) income tax rate states (e.g. Delaware) to hold such assets as trademarks, patents, etc. Those asset-holding entities then charge license fees to their affiliated operating entities for the use of such assets in higher income tax rate states (e.g. West Virginia at 8.75%). The deductions the operating entities take from their taxable income for payment of those fees result in a shifting of their income from the high rate states to the low (or 0%) rate states. The deductions are taken when arriving at federal taxable income. When a business purpose exists (aside from state tax avoidance) for establishing the trademark holding company the business expense deduction is a legitimate cost of doing business. The problem is that many Delaware intangible holding companies are little more than a name and a post office box number.

In the mandatory unitary combination states, an often litigated issue is whether the intangible asset-holding company is engaged in a unitary business with the operating affiliate and, therefore, required to be included in a combined report of their income. Then too, sometimes only one division of a multi-division multistate corporation is engaged in unitary business activity with other corporations. In this situation, the combined report would not include the income and expenses of the divisions engaged in non-unitary business activity. In states where the separate reporting election is allowed, subject to denial if the tax agency believes it distorts income (including West Virginia under pre-SB 749 law), there also is litigation over whether certain income shifting arrangements have a legitimate business purpose.

C. Issues Raised by Unitary Combined Reporting

The mandatory combined reporting requirements of SB 749 will have mixed effects on affiliated groups of corporations that do not operate outside the state. Because the state consolidated return is eliminated, even the parent-subsidary group of corporations that does business only in West Virginia will be required to file a combined report and each corporation will be required to file a separate return unless the group elects to file a combined return under §11-24-13e. The bill's impact on the income tax liability of other corporations (and groups of corporations) with operations outside the state, will vary depending on the interplay of a number of factors in the case of any given group. However, there are a number of other consequences of SB 749 that should be noted in terms of its impact on business climate, as viewed by external investment sources.

² According to the Center's website, Mazerov is an Oberlin and Yale-educated policy analyst who has performed policy research for, among others, the MTC and the American Federation of State, County and Municipal Employees (AFSCME).

Experience and a review of recent literature suggests that multi-state and multi-national businesses will, unless changes are made, perceive the state's adoption of mandatory unitary combined reporting as represented in SB 749 as a negative for doing business in West Virginia. This is evidenced, in part, by the extremely aggressive actions by states such as California to attempt to tax income earned from activity not only in other states but in foreign countries as well. In the mid-1980s, West Virginia repealed its membership in the MTC, and expressly announced its lack of interest in mandatory unitary combined reporting in order to avoid discouraging investment by such businesses in the state. To administer its combined reporting requirements, West Virginia will likely need to become more involved in the MTC.

The particular version of mandatory unitary combined reporting found in SB 749 is based on a model statute promoted by the MTC. As such, it is even more far-reaching than California's world-wide combination version with a "water's-edge" election (limiting a combined group's tax base to its domestic U.S. business activity). That is the case because SB 749 includes a definition of the term "tax haven" not found in the California law which allows the Tax Commissioner to include, in the combined report of the unitary group, the income of a foreign member of the group that is derived from a tax haven jurisdiction. It also gives the Tax Commissioner the discretion to entirely disregard a water's-edge election if the group has an affiliate "availed of with a substantial objective of avoiding state income tax." §11-24-13f(b)(3).

Today, West Virginia's reactivated involvement in the MTC (initially in connection with the Streamlined Sales Tax Project), and the broad discretion given the Tax Commissioner in SB 749 to disallow a multi-national corporation's water's edge election, will likely do little to allay the concerns of those multi-state and multi-national businesses currently doing business in West Virginia as well as those considering investing in the state.

On the other hand, Mazerov asserts--with little substantive analysis--a significant statistical correlation between states adopting such rules and economic development successes. In doing so, he reveals his own more fundamental tax policy biases by contending that state and local taxes are not a significant factor in multi-state corporate investment decisions. Importantly, none of the tax structures of the "success story" states to which he refers punish job-creating capital investment as West Virginia's does via its BFT and property taxes on business inventory, machinery and equipment.

The Council on State Taxation (COST) is a non-profit trade association of major corporations engaged in interstate and international business. In a letter to Governor Manchin dated March 15, 2007, COST president Douglas Lindholm urged the Governor to veto SB 749. His letter states, in part:

"COST neither supports nor opposes state enactment of unitary combined reporting (unless, as is the case with Senate Bill 749, the enacting legislation fails to provide for an appropriate water's-edge election and includes other objectionable provisions, such as failing to apply the unitary theory to both income and deductions). Unitary combined reporting will lower taxes for some companies and raise them for others. However, moving from separate entity reporting to mandatory unitary combined reporting is a radical change that

eviscerates the concept of consistency in tax reporting. Moreover, the goals underpinning such a change can frequently be accomplished by less radical legislation. Regardless, the consequences of such a change must be carefully considered. If a state chooses to adopt unitary combined reporting, it must provide clear and objective measures for making unitary determinations. Consistently applied, objective unitary measures will aid taxpayers in complying with this complicated filing method and reduce administrative costs for unitary combined reporting states.”

As previously indicated, the question of what constitutes unitary business activity in the case of multi-state/multi-national companies--particularly diversified conglomerates--rarely has a simple answer.³ Unfortunately, it is also a question with which West Virginia tax administrators have little experience. Moreover, the current or expected capacity of the State Tax Department to have sufficient numbers of trained auditors to examine the records of such taxpayers, in order to apply the unitary business rules, is seriously in doubt. The Department will need taxpayer service representatives, internal auditors, lawyers and field auditors who are all trained to administer forced world-wide combination reporting, the water’s-edge election, and the difficult concept of unitary business.

In many instances the amounts on a combined report will not tie back to the amounts on the taxpayer’s federal income tax return, whether a consolidated or separate return is filed. In those instances, it will be difficult for the State Tax Department to piggyback on federal return adjustments made by the IRS, thus defeating one of the primary reasons the Legislature requires the use of federal taxable income (with terms annually updated) as the starting point for determining West Virginia taxable income. *See* §11-24-1 (legislative findings).

Mandatory unitary combined reporting proponents would rebut these administrative concerns by pointing to West Virginia’s access to MTC auditing expertise in applying unitary combined reporting rules. The theoretical appeal of that point is diminished, however, in practice when the inquiries of taxpayers which challenge unitary audit findings are met by nothing more than ambiguous explanations by the State Tax Department and the MTC audit staff in Chicago.

Thus, given the stakes at issue, the ambiguity and complexity of the key substantive rules and West Virginia’s inexperience with such matters, it can be expected that substantial litigation will ensue over the application of those rules. For those same reasons, the estimates of increased revenues resulting from combined reporting (approximately \$33 million annually) on which the Legislature relied in enacting SB 749 were admittedly presented by the Department of Revenue without a great deal of confidence, much less quantitative precision.

Likewise, to gain a truly accurate picture of the state revenue implications of adopting combined reporting, in addition to the projected benefits from curbing the abuses of income manipulation by multi-state/multi-national businesses, the cost of administering the new law must be

³ The definition of “unitary business” describes a group of business entities “that are sufficiently interdependent, integrated and interrelated through their activities 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.” §11-24-3a(30).

determined--as well as how many dollars will not be invested in West Virginia, and how much less new taxable income will be generated in the state, as a result of it.

The negative business climate image, the uncertainty of revenues and the other related difficulties threatened by the shift to mandatory unitary combined reporting were not inevitable. Rather, the rate reduction in the CNIT that the Governor's Tax Modernization Project proposed, the Chamber supported and the Senate passed (Senate Bill 750) in 2007 may have gone a long way in removing the incentive to engage in the manipulative abuses that unitary combined reporting is intended to prevent.

At the same time, it is important to remember that the Legislature has in the recent past considered other, far more precise, effective and less broadly onerous methods to address those same abuses (*see* reference to House Bill 4670 *infra*). All of this suggests the need for both an effort to refine the more problematic specific provisions of mandatory unitary combined reporting contained in SB 749 and a more deliberate, in-depth understanding of its broader policy aspects.

II. COMBINED REPORTING OPTIONS

The driving force behind SB 749 is the perceived abuse by companies to divert West Virginia earnings to affiliates in low-tax or no-tax states, thus avoiding West Virginia taxes. This perceived abuse exists because of a lack of uniformity in state filing options which means tax practitioners can carefully analyze the filing options available in any given nexus state for their clients.

The following are options to consider: (1) mandatory separate company returns; (2) elective consolidated returns; (3) mandatory combined unitary reporting; (4) add back of certain expenses; (5) discretionary combined unitary reporting; (6) a hybrid system, which includes both elective consolidated returns and discretionary combined unitary reporting; and (7) other methods.

(**Bolded** states below are West Virginia and its Border States.)

(1) *Mandatory Separate Company Returns* – At least five states, including Delaware, **Maryland**, **Pennsylvania**, (pre-2007) Texas and Wisconsin, require each member of a commonly controlled group of corporations to compute its income and file a return as if it were a separate economic entity. Under this mandatory separate company return approach, consolidated returns and combined reporting are not permitted or required under any circumstances. Additionally, in Delaware, an “affiliated group of Headquarters Management Corporations” may elect to make a consolidated return with respect to the income tax imposed by §6402 for the taxable year in lieu of separate returns. The making of a consolidated return shall be considered the election and consent of all members of the affiliated group. The tax due by an affiliated group of Headquarters Management Corporations filing a consolidated return shall be no less than the tax payable under §6402(2) multiplied by the number of members reporting on the consolidated return.” 64 Del.C. § 6404.

The filing of separate company returns provides taxpayers with the opportunity to create legal structures and inter-company transactions that shift income from affiliates based in high-tax states to affiliates based in low-tax or no-tax states. The disadvantages of the separate company return approach include the inability to offset the losses of one affiliate against the profits of other affiliates and the need to develop defensible arm’s-length transfer prices for inter-company transactions.

(2) *Elective Consolidated Returns* – A number of states, including Alabama, Florida, Georgia, Iowa, Massachusetts, South Carolina and **West Virginia (pre-SB 749)**, permit affiliated corporations to elect to file a state consolidated return if certain conditions are met. Additionally, in some states, e.g., Alabama and Arkansas, the only members of the federal affiliated group that may be included in the consolidated state return are those with taxable nexus with the taxing state. The qualification requirements for including an affiliated corporation in a state consolidated return vary from state to state. In terms of stock ownership requirements, many states piggyback on the federal rule requiring 80 percent or more ownership.

A number of states also require that the affiliated group file federal consolidated return as a prerequisite to filing a state consolidated return. The advantages of filing a consolidated return include the ability to offset the losses of one affiliate against the profits of other affiliates, elimination of inter-corporate dividends, deferral of gains on inter-company transactions, and the use of credits that would otherwise be denied because of a lack of income. From a state's perspective, a major disadvantage of filing a consolidated return is that it prevents a taxpayer from creating legal structures and inter-company transactions to shift income from affiliates.

(3) *Mandatory Unitary Combined Reporting* -- About 17 states, including Alaska, Arizona, California, Colorado, Idaho, Kansas, Illinois, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Utah, Vermont **and West Virginia (post-SB 749)**, require members of a unitary business group to compute their taxable income on a combined basis. Roughly speaking, a unitary business group consists of two or more commonly controlled corporations that are engaged in the same trade or business, as exhibited by such factors as functional integration and centralized management. Other states to enact a form of forced combination are Texas, New Hampshire and New York (2007).

(4) *Add-Back of Certain Expenses* -- A form of combined reporting that has found favor in recent years is the related party expense add-back provisions. To close the perceived loopholes, many states have enacted laws that require a corporation to add back to federal taxable income any royalties or interest expense paid to related parties when computing its state taxable income. Most of the state add-back provisions have been in existence for only a few years. The states that enacted such provisions are as follows: Alabama, Arkansas, Connecticut, District of Columbia, Georgia, Illinois, **Kentucky**, **Maryland**, Massachusetts, Mississippi, New Jersey, North Carolina, Oregon, Tennessee and **Virginia**.

Although the different state add-back provisions share many common themes, there are significant differences, particularly with respect to the circumstances under which an exception applies and the related party expense need not be added back. However most provisions are generally targeted at two broad categories of expense: "intangible expenses" and "interest expense." Kentucky's add-back provision also applies to management fees. In some states, the interest expense add-back provisions apply only to interest expense that is related to intangible property.

NOTE: In 2004, the House Finance Committee originated and the House passed House Bill 4670,⁴ sponsored by Finance Chair Michael and Delegates Doyle, Stalnaker, Boggs, Hall, G. White and Border. The bill would adopt a form of combined reporting and require certain corporations to add back certain intangible and interest expenses if the Tax Commissioner determined that it is necessary to properly reflect taxable income. The State Tax Department could not produce a fiscal note for the bill, stating that it "does not have access to the data necessary" to calculate its fiscal impact.

(5) *Discretionary Combined Reporting* -- Roughly 20 states, including Michigan, New York, North Carolina, and **Virginia**, generally allow commonly controlled corporation to file separate

⁴ See Appendix B.

company returns, but also require or permit a combined unitary report if certain conditions are satisfied. A common reason for requiring a combined report is the state tax authority's determination that combined report is necessary to clearly reflect the group's income earned in the state or prevent the evasion of taxes.

For example, New York does not permit an affiliated group to elect to file a consolidated return nor does it require a unitary group to compute its income on a combined basis in all cases. Thus, every corporation with nexus in New York is generally considered a separate entity and must file its own return. The New York Tax Commission may, however permit or require two or more commonly controlled corporations that are engaged in a unitary business to file a combined report "if reporting on separate basis distorts the activities, business, income or capital in New York. In addition, it is presumed that distortion exists if there are "substantial inter-corporate transactions" among the corporations in question. To rebut this presumption, the taxpayer must prove that it used arm's length transfer prices to account for its inter-corporate transactions.

However, for taxable years beginning after December 31, 2006, a group meeting the capital stock and unitary business requirements are required to file a combined report in New York if there are substantial inter-corporate transactions among the related corporations, regardless of the transfer price for the inter-corporate transactions. Regulations promulgated under the New York law generally provide that in determining whether substantial inter-corporate transactions exist, the facts and circumstances of all activities and transactions between related corporations and the taxpayer must be examined, including the following: (a) manufacturing, acquiring goods or property, or performing services for related corporations; (b) selling goods acquired from related corporations; (c) financing sales of related corporations; (d) performing related customer services using common facilities and employees for common customers of related corporations; (e) incurring expenses that benefit, directly or indirectly, one or more related corporations, and (f) transferring assets, including such assets as accounts receivable, patents or trademarks from one or more related corporations. Therefore, inter-corporate receipts, inter-corporate expenditures and inter-corporate transfers of assets all constitute an inter-corporate transaction.

It is not necessary that there be substantial inter-corporate transactions with every member of the unitary group. Foreign corporations may not be included in a combined report. Real estate investment trusts and regulated investment companies must be included in the combined report if substantially all of their capital stock is owned or controlled, directly or indirectly, by one or more corporations that are subject to the corporate franchise tax, or be included in a combined report with a corporation that is subject to the corporate franchise tax. Moreover, the federal deduction for dividends paid is not allowed.

(See Appendix C for a Taxpayer Guidance Analysis of combined reporting requirements prepared for the New York State Department of Taxation and Finance.)

(6) *Hybrid Approach* -- Some states, such as **Virginia**, employ both the elective consolidation and the discretionary combined unitary reporting approaches. For example, a state may provide affiliated corporations that satisfy certain requirements with the option of filing a consolidated or combined return in lieu of filing separate entity returns. At the same time, state tax authorities

may require a group of unitary affiliates to file a combined report if such a report is deemed necessary to clearly reflect the amount of the group's income earned in the state.

(7) *Other Methods* -- Texas has, for tax years ending prior to 2007, a corporate franchise tax based on a corporation's capital and earned surplus. For purposes of computing this tax, each affiliate with nexus in Texas is considered a separate taxable entity and files on a separate company basis. Effective for tax years ending after 2006 this tax is replaced with a new margin tax. Members of an affiliated group of corporations that are engaged in unitary business must compute their margin on a combined basis.

The Chamber believes that the Legislature should consider New York's *quasi-discretionary combined reporting* approach, or *add-back of certain expenses* as envisioned in HB 4670 (2004), as a substitute to the process enacted in SB 749. In any case, the option to file a West Virginia consolidated return when a federal consolidated return is filed should be retained and be in lieu of any requirement to file a combined report.

III. RECOMMENDED CHANGES TO SB 749

If the SB 749 combined reporting process is to be retained, or even if the New York version of forced combination is adopted, the Chamber believes that a number of substantive changes should be made and offers the following recommendations.

NOTE: The order of the recommendations below are by no means indicative of their order of importance.

A. Single-Factor Apportionment

Under current West Virginia law, most corporations apportion the business income portion of their adjusted federal taxable income using a three-factor formula – property, payroll and sales – in which the sales factor is double weighted. The double weighting of the sales factor was adopted in 1985. Corporations currently required to use a different method of apportionment include (1) motor carriers, which apportion using a single factor -- mileage -- as provided in §11-24-7a(b); (2) in-state financial organizations, which are not allowed to apportion their business income as provided in §11-24-7(c); and (3) out-of-state financial organizations doing business in West Virginia which apportion their business income using a special sales factor as provided in §11-24-7b.

Under SB 749, all corporations will be required to apportion their business income using a three-factor formula – property, payroll and sales – in which the sales factor is double weighted, for taxable years beginning after December 31, 2008 unless the Tax Commissioner requires, or the taxpayer receives permission to use, another method of apportionment, as provided in §11-24-7(h), or the Tax Commissioner requires use of a different method, as provided in §11-24-13a(k)(3).

The economic effect of the three-factor formula is a tax on jobs, a tax on business investments, and a tax on gross receipt. West Virginia has reduced the tax on jobs and the tax on business investment to some extent by double-weighting the sales factor. But now that more states are placing a greater weight on the sales factor, it is time to consider reducing the taxes on jobs and business investment even further.

When a state reduces the implicit taxes on payroll and property, by increasing the weight given to the sales factor, it increases the after-tax returns of corporations that make or have made a large capital investment in West Virginia and created jobs in the state. By reducing the implicit tax on business investment and jobs, West Virginia becomes more attractive to businesses intending to make capital investments and create jobs.

Apportionment factors used by West Virginia and its Border States* are:

West Virginia – 50% sales, 25% property and 25% payroll
Kentucky -- 100% sales
Maryland -- 50% sales, 25% property and 25% payroll
Ohio -- 60% sales, 20% property and 20% payroll

Pennsylvania -- 75% sales, 12.5% property and 12.5% payroll
Virginia -- 50% sales, 25% property and 25% payroll

Other states utilizing only the sales factor to apportion business income include Illinois, Iowa, Nebraska, Oregon and Texas.* Interestingly, all of these states require combined reporting, except for Iowa, and the Governor of Iowa has recommended that his state enact combined reporting legislation. Other states that more heavily weight the sales factor include Arizona (60%), Georgia (90%), Indiana (60%), Michigan (92.5%), Minnesota (78%), New York (80%) and Wisconsin (80%).*

While adopting a single factor--sales--as the method for apportioning business income is likely to reduce tax collections in the short term that decrease in revenue will be offset by increased economic activity that will result from making West Virginia more attractive for business investment and job creation. Moreover, adopting the single factor for taxable years beginning after December 31, 2008--which is an economic plus--will help offset the economic negative of mandatory combined reporting.

Another reason for adopting sales as the single factor apportionment formula is that the three-factor formula was adopted when the nation and West Virginia had a smokestack, bricks and mortar economy. The shift in the national economy and the West Virginia's economy to a services-based economy means that a greater portion of today's economic activity is being provided by businesses that have less or no capital investments in West Virginia and that have smaller or no payrolls in the state.

With a substantial majority of West Virginia's population residing in border areas, considerable services are being provided in the state by out-of-state businesses that may have little or no property in West Virginia and that have little or no payroll in the state and, yet, have considerable West Virginia sales. A fair question to ask whether these out-of state businesses are paying their fair share particularly when compared to their West Virginia based business competition which pay BFT on their capital, and pay a second tax on their capital and a tax on their jobs when they compute their West Virginia CNIT liabilities.

Adoption of single-factor--sales--apportionment is a fairness issue, an economic development issue, and a tax simplification issue for businesses subject to the West Virginia CNIT and BFT.

*Source: Federation of Tax Administrators, www.taxadmin.org/fta/rate/corp_app.html

B. Throw Out Rule

The CNIT includes what is commonly know as the sales "throw out" rule which excludes from the denominator of the sales factor all sales made by the taxpayer to customers in another state in which the taxpayer is not taxable. §11-24-7(e)(11) provides:

“(11) Allocation of sales of tangible personal property.

(A) Sales of tangible personal property are in this state if:

(i) The property is received in this state by the purchaser, other than the United States government, regardless of the f.o.b. point or other conditions of the sale. In the case of delivery by common carrier or other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered as the place at which such property is received by the purchaser. Direct delivery in this state, other than for purposes of transportation, to a person or firm designated by the purchaser, constitutes delivery to the purchaser in this state, and direct delivery outside this state to a person or firm designated by the purchaser is not delivery to the purchaser in this state, regardless of where title passes or other conditions of sale; or

(ii) The property is shipped from an office, store, warehouse, factory or other place of storage in this state and the purchaser is the United States government.

(B) All other sales of tangible personal property delivered or shipped to a purchaser within a state in which the taxpayer is not taxed, as defined in subsection (b) of this section, shall be excluded from the denominator of the sales factor.” (Emphasis added)

For purposes of the highlighted language above, a taxpayer is treated as being “taxed” in a particular state if the taxpayer is actually subject to an income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax, imposed by another state, or if the taxpayer would be subject to such a tax if the state imposed such a tax. §11-24-7(b) (defining taxable in another state) provides:

“(b) *‘Taxable in another state’ defined.* For purposes of allocation and apportionment of net income under this section, a taxpayer is taxable in another state if:

(1) In that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax; or

(2) That state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, that state does or does not subject the taxpayer to such tax.”

The term “state” is broadly defined in the CNIT to also include the Commonwealth of Puerto Rico, territories and possessions of the United States, and foreign countries or political subdivisions thereof. §11-24-3a(21) provides:

“(21) *State.* -- The term “state” means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or

possession of the United States and any foreign country or political subdivision thereof.”

Legislative rules for the CNIT essentially repeat the statutory language of the sales throw out rule and do not address any of the issues associated with that rule. WVCSR §110-24-17.18 provides:

“7.18. Allocation of sales of tangible personal property.

7.18.1. Sales of tangible personal property are in this State if the property is received in this State by the purchaser, other than the United States government, regardless of the f.o.b. point or other conditions of the sale. In the case of delivery by common carrier or other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered as the place at which such property is received by the purchaser, regardless of where title passes or other conditions of sale. Direct delivery in this State, other than for purposes of transportation, to a person or firm designated by the purchaser, constitutes delivery to the purchaser in this State, and direct delivery outside this State to a person or firm designated by the purchaser does not constitute delivery to the purchaser in this State, regardless of where title passes or other conditions of sale. The sales of tangible personal property are also in this State if the property is shipped from an office, store, warehouse, factory or other place of storage in this State and the purchaser is the United States government.

7.18.2. All other sales of tangible personal property delivered or shipped to a purchaser within a state in which the taxpayer is not taxed are excluded from the denominator of the sales factor.

7.18.2.1. "Not taxed in another state" means in that state the taxpayer is not subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax or that a state has no jurisdiction to subject the taxpayer to a net income tax.” (Emphasis added)

Under West Virginia’s throw out rule, sales of tangible goods to customers in a state in which the corporation has a taxable presence but which does not impose an income tax, would be excluded from the denominator of the West Virginia sales factor. On the other hand, sales made to customers in a state that cannot tax the corporation because of federal Public Law 86-272 would be excluded from the denominator of the sales factor. Additionally, the sales to be excluded from the denominator are not limited to sales that originate in West Virginia. All nontaxable sales are thrown out of the denominator regardless of whether they have any connection to West Virginia. West Virginia and New Jersey are the only states that have adopted the throw out rule.

C. Throwback Rule

The sales factor adjustment rule used by a number of states is known as the “throwback” rule. When the throwback rule is applied, it adds to the numerator of the sales factor those sales that originated in the taxing state but were shipped to a state in which the corporation is not subject to an income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax.

The throw out rule presents a problem when determining the group’s denominator of the sales factor when some but not all members of the combined group have a taxable presence in all of the states in which the group engages in its unitary business activity. This same problem does not exist when a taxing state employs the throwback rule. This is because the numerator of the sales factor is determined separately for each member of the combined group that engages in unitary business activity in the taxing state when it files its separate income tax return. However, when a combined return is filed in the taxing state using the numerator and denominator of the sales factor for the unitary group, a similar problem can exist when not all members of the combined group engaged in the unitary business activity have a taxable presence in the taxing state.

None of West Virginia’s Border States employ either the sales throwback rule or the sales throw out rule. To simplify administration and compliance under a combined reporting regime such as SB 749, the Chamber recommends that the sales throw out rule be repealed and that the rule not be replaced by the sales throwback rule.

This change in the law can be effectuated by amending §11-24-7(e)(11) to provide:

“(11) Allocation of sales of tangible personal property.

~~(A)~~ Sales of tangible personal property are in this state if:

~~(i)~~ (A) The property is received in this state by the purchaser, other than the United States government, regardless of the f.o.b. point or other conditions of the sale. In the case of delivery by common carrier or other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered as the place at which such property is received by the purchaser. Direct delivery in this state, other than for purposes of transportation, to a person or firm designated by the purchaser, constitutes delivery to the purchaser in this state, and direct delivery outside this state to a person or firm designated by the purchaser is not delivery to the purchaser in this state, regardless of where title passes or other conditions of sale; or

~~(ii)~~ (B) The property is shipped from an office, store, warehouse, factory or other place of storage in this state and the purchaser is the United States government.

~~(B) All other sales of tangible personal property delivered or shipped to a purchaser within a state in which the taxpayer is not taxed, as defined in subsection (b) of this section, shall be excluded from the denominator of the sales factor.”~~

D. Financial Organizations

Prior to enactment of SB 749, special apportionment rules have been applied to banks. These apportionment rules have been in place since 1991 and were developed in cooperation with the West Virginia Bankers Association. These rules have required banks and other financial organizations domiciled in West Virginia to apportion their income to West Virginia even if taxed by another state. To the extent the financial institution’s income was taxed in another state, a credit was permitted. This credit was computed as the lesser of the tax paid the other state(s) or the West Virginia CNIT computed on the income taxed by the other state(s).

Financial organizations domiciled outside of West Virginia that regularly engage in business both within and without West Virginia have been required to apportion their taxable income based on a single factor apportionment. This special gross receipts factor is a fraction, the numerator of which is the total gross receipts of the taxpayers from sources within this State during the taxable year and the denominator of which is the total gross receipts of the taxpayers wherever earned during the taxable year.

The numerator of the gross receipts factor shall include:

- Receipts from the lease or rental of real or tangible personal property;
- Interest income and other receipts from assets in the nature of loans;
- Interest income and other receipts from commercial loans;
- Interest income and other receipts from a financial organization’s syndication;
- Interest income and other receipts, including service charges;
- Merchant discount income derived from financial institution credit card holder transactions;
- Receipts from the performance of services which are attributed to this State if:
 - The service receipts are loan-related fees;
 - The service receipts are deposit-related fees;
 - The service receipts is a brokerage fee;

- The service receipts are fees related to estate or trust services;
 - The service receipt is associated with the performance of any other service not previously identified and the service is performed for an individual resident of, or for a corporation or other business domiciled in West Virginia and the economic benefit of such service is received in this State; and
- Gross receipts from the issuance of travelers' checks and money orders.

The denominator of the gross receipts factor is to include all of the taxpayer's gross receipts from transactions of the kind described above.

A financial organization with its commercial domicile in another state is presumed to be regularly engaging in business in West Virginia if during any year, it obtains or solicits business with 20 or more people in the state or if the sum of the value of its gross receipts attributable to West Virginia equals or exceeds \$100,000.

The validity of the West Virginia statute recently was upheld in a court challenge.⁵ In this case, MBNA argued that it did not have any real or tangible personal property nor any employees located in West Virginia. The state argued that a physical presence is not required to show a substantial nexus for purposes of state's taxation of financial institutions domiciled outside the state. Rather, the State argued that MBNA's significant business in the state was sufficient to meet the substantial nexus standard of the Commerce Clause. The West Virginia Supreme Court of Appeals ruled that the imposition of West Virginia's business franchise tax and corporation net income tax on MBNA for the years 1998 and 1999 did not violate the Commerce Clause. The U.S. Supreme Court recently rejected an appeal of the case.

The Chamber believes the decision in MBNA to be significant. Respondent, MBNA, derived significant revenues from this state. It was able to generate these revenues without investing in physical facilities or employing West Virginia based labor. If the West Virginia Supreme Court had found in favor of MBNA, West Virginia domiciled financial institutions would have been placed at a competitive disadvantage. The Chamber believes this case to be illustrative of how special provisions should exist for financial institutions.

While not the central focus of the MBNA decision, the Chamber recommends attention be drawn to the method(s) of apportioning income for financial institutions engaged in multi-state activity. Prior to SB 749, financial institutions domiciled in West Virginia were required to apportion 100% of their taxable income to the state. They were permitted to claim a credit for taxes paid to other states for which income may have been apportioned. However, inasmuch as Virginia, Pennsylvania, Kentucky and Ohio do not tax banks on their taxable income (each of these states impose a franchise tax on a bank's capital), the credit provisions under "old" law were less than effective. This placed West Virginia domiciled financial institutions at a competitive

⁵ Tax Commissioner of the State of West Virginia v. MBNA America Bank, N.A., 640 SE2d 226 (2006)

disadvantage compared to non-domiciled financial institutions transacting business in West Virginia.

The Chamber strongly contends that financial institutions should be not penalized for having West Virginia as their domicile. The Chamber further believes that taxes should be derived from financial institutions based solely on their financial activity, irrespective as to their state of domiciliary.

Prior to SB 749, financial institutions domiciled outside of West Virginia apportioned their taxable based on a single factor. As illustrated under MBNA, an investment in facilities and West Virginia based labor is not required in today's environment in order for a financial institution to generate significant revenues from West Virginia. The Chamber believes that traditional West Virginia based financial institutions should not be disadvantaged by investing in physical facilities and hiring a West Virginia work force.

SB 749 would have financial institutions apportion their income to West Virginia based on a three factor apportionment calculation. The apportionment is determined by reference to the institution's sales, property and payroll attributed to West Virginia. (The sales/revenue calculation is double weighted in arriving at the state's apportionment.) Under SB 749, financial institutions not having a physical presence in West Virginia, such as MBNA, would likely see a reduction in their overall apportionment compared to present law inasmuch as they have not invested in physical presence in West Virginia.

The Chamber proposes the following changes to SB 749 that would capitalize on the state's success in MBNA while providing a level playing field for West Virginia domiciled financial institutions:

- ▶ **Retain the nexus standards found in the statute prior to SB 749 insofar as non-domiciled financial institutions;**
- ▶ **Retain single factor apportionment found in the statute prior to SB 749;**
- ▶ **Clarify SB 749 to indicate that, if the state's "throw out" provisions are not repealed, they shall not apply to revenues generated by financial institutions outside of West Virginia.**

E. Motor Carriers

Under pre-SB 749 law, the income of a motor carrier is apportioned based on mileage rather than the more traditional three-factor apportionment formula found in SB 749. The Chamber contends that mileage is a fair and prudent basis for apportionment of income. The motor carrier industry is by its very nature mobile. Inter-state carriers frequently travel through West Virginia, competing with carriers based in this state. West Virginia carriers should not be penalized for basing its operations in this state, hiring its residents and locating its offices here. Moreover, apportioning income through use of a mileage-based formula recognizes that a carrier's property (in the form of its transportation equipment) and the labor employed to drive that equipment are

reasonably apportioned based on the mileage generated in West Virginia compared to mileage generated everywhere. Lastly, the state would likely benefit by retaining a mileage apportionment formula inasmuch as apportionment percentages could be easily verified through reference to a carrier's fuel tax filings.

The Chamber recommends that the pre-SB 749 special apportionment rules with respect to motor carriers be retained.

F. Partnerships

Under law in effect for the 2007 and 2008 tax years, a corporate partner's distributive share of partnership items to the extent sourced to West Virginia are treated as income allocated to West Virginia. §11-24-7(d)(5) provides:

“(5) Corporate partner's distributive share.

(A) Persons carrying on business as partners in a partnership, as defined in §761 [26 U.S.C. Sec. 761] of the Internal Revenue Code of 1986, as amended, are liable for income tax only in their separate or individual capacities.

(B) A corporate partner's distributive share of income, gain, loss, deduction or credit of a partnership shall be modified as provided in section six of this article for each partnership. For taxable years beginning on or after the thirty-first day of December, one thousand nine hundred ninety-eight, the distributive share shall then be allocated and apportioned as provided in this section, using the partnership's property, payroll and sales factors. The sum of that portion of the distributive share allocated and apportioned to this state shall then be treated as distributive share allocated to this state; and that portion of distributive share allocated or apportioned outside this state shall be treated as distributive share allocated outside this state, unless the taxpayer requests or the tax commissioner, under subsection (h) of this section requires that such distributive share be treated differently.”

While SB 749 did not repeal §11-24-7(d)(5), the requirements of that subdivision are in conflict with other provisions of SB 749, at least when the partnership is part of the unitary business. The following discussion focuses on four provisions of SB 749.

First, the definition of “corporation” was amended in SB 749 by adding the first two sentences and retaining the original definition as the third sentence. The second sentence pertains to partnerships and partnership income and provides that the business and income of a corporate partnership are considered to be the business and income of the corporation to the extent of the corporation's ownership of the partnership. As amended, §11-24-3a (5) provides:

“(5) *Corporation.* -- “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. The term “corporation” includes a joint-stock company and any association or other organization which is taxable as a corporation under the federal income tax law.” (Emphasis added)

Second, language pertaining to partnerships included in the MTC model statute on combined reporting was, omitted from the SB 749 definition of unitary business. There is no legislative record by which to determine whether this omission was intentional or inadvertent.

If the SB 749 definition of “unitary business” included the omitted language, it would read as follows, with the omitted language underscored:

“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. 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.”

Under the MTC model statute on combined reporting, business conducted by a corporation through a partnership is treated as conducted directly by that corporation, to the extent of the corporation’s distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership.⁶

Third, new §11-24-13c (determination of taxable income or loss using combined report) requires that “[t]he 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 thirteen-d of this article and the denominator of which is the amount of the partnership’s total unitary income.” (Emphasis added)

⁶ See MTC Hearing Officer’s Report of April 25, 2005, p. 5.

§11-24-13c(c) provides:

“(c) 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:

(1) The business income of the combined group, determined under section thirteen-d of this article; and

(2) The taxpayer member’s apportionment percentage, determined in accordance with this article, 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 thirteen-d of this article and the denominator of which is the amount of the partnership’s total unitary income.” (Emphasis added)

Fourth, new §11-24-13d (determination of business income of combined group) includes partnership income as business income subject to apportionment, when the partnership is engaged in unitary business activity. §11-24-13d(c) provides:

“(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.”

The language regarding treatment of partnerships added to the definition of “corporation,” §11-24-3a(5), and included in §11-24-13c(c) and §11-24-13d(c) leads the Chamber to conclude that the “partnership language” was unintentionally omitted from the SB 749 definition of unitary business.

Under the MTC model statute on combined reporting, business conducted by a corporate income taxpayer through a partnership is treated as conducted directly by the corporate taxpayer, to the extent of the corporation’s distributive share of the partnership income. This is the treatment whether the partnership is a general partnership, a limited partnership, a limited liability company or other entity treated as a partnership, or an S corporation. Because the corporation is considered to be engaged in the partnership business directly, as though a division of the corporation, the corporate partner’s distributive share of partnership income and factors “flow up” for apportionment purposes on the partner, as opposed to remaining at the partnership level, irrespective of any threshold level of the partnership’s ownership interest, distributive share or

any other measure of the corporation's stake in the partnership. Under this statutory "as if done directly" treatment, if a partnership has state source income, so will the partner. The MTC believes this treatment is consistent with federal sourcing rules that treat a resident of a foreign country as having U.S. source income if the partnership or S corporation of which the resident is a member has income from a US source, IRC § 875(1); Treas. Reg. 1366(b). This approach was sustained in state court, in *Valentino v. Franchise Tax Board*, 87 Cal.App.4th 1284 (2001).⁷

The Council on State Taxation suggested that the MTC model statute should explicitly specify whether it follows the "aggregate" or the "separate" theory and noted the myriad of issues that arise from the inclusion of partnership income in the combined report. The Hearing Office believed that the model statute is reasonably clear regarding the basic policy to be followed, but agreed that additional, more detailed guidance could be provided, and recommended that such be done through regulation. To date, the MTC has not promulgated model regulation explaining and clarifying its model statute on combined reporting.

Pre-SB 749 Treatment of Partnership Income -- §11-24-7(d)(5) was enacted in 1988 to avoid having partnership income sourced to West Virginia, using formulary apportionment, further apportioned by including the partnership income in the business income of the corporation, which was then apportioned as provided in §11-24-7(e). It appears that the SB 749 treatment of corporate partnerships engaging in unitary business activity reestablishes the double apportionment issue that generated the 1988 amendment.

The Conflict -- There are several ways to view the SB 749 partnership issue. First, perhaps the Legislature intended to retain the current law policy of having a corporation's share of partnership income allocated and apportioned to West Virginia reported as income allocated to West Virginia, as provided in §11-24-7(d)(5). Second, perhaps the Legislature intended to change the rules for all corporations owning interests in partnerships doing business in West Virginia, so that the CNIT is consistent with how other states treat corporate partnership income. The third possibility is that the Legislature intended to treat partnerships that are engaged in unitary business activity with other members of the combined group as provided in §11-24-13c and §11-24-13d, and to treat corporate partnerships not engaged in unitary business activity in the manner provided in §11-24-7(d)(5). Regardless of the policy decision, the point to be made here is that remedial legislation is needed to clarify how corporate partnership income, gains, losses, tax credits and apportionment factors are to be treated for taxable years beginning after December 31, 2008.

Even if it would be reasonable and constitutional to tax corporate partners differently depending upon whether the partnership is engaged in a unitary or non-unitary business activity, the next question is whether doing so is desirable or undesirable tax policy for West Virginia. The Chamber's conclusion is that tax treatment should not depend upon whether the partnership is engaged in unitary business activity. All corporate partners should be treated alike. The better policy is to retain §11-24-7(d)(5) for all corporate partnerships and to appropriately amend the other provisions of SB 749.

⁷ See MTC Hearing Officer's Report of April 25, 2005, p. 5.

G. Utilization of West Virginia Tax Credits

Senate Bill 749 may have a significant adverse impact on the ability of corporations doing business in West Virginia, including manufacturers, to offset their CNIT and BFT liability using various tax credits for which they have qualified, including the Economic Opportunity Tax Credit (EOC), the Agricultural Equipment Credit, the Wood, Steel, Aluminum and Polymer Manufacturing Credit, the Manufacturing Investment Credit and the Strategic Research & Development Credit.

§11-24-13c(b)(2) provides that tax credits earned by one member of a unitary group may only be used against the West Virginia tax liability of that member and cannot be used to offset taxes attributable to other members of the group which did not earn the tax credit. This provision could have a significant adverse effect on a group of unitary manufacturers where one member of the unitary group operates a manufacturing or research facility in this state and has qualified for West Virginia tax credits.

The following example shows how S.B. 749 may result in a significant reduction in taxpayer's West Virginia tax credits and significantly increase the tax liability of the unitary group.

West Virginia EOC Credit - Combined Filing Example

WV-MFG operates a manufacturing facility in West Virginia that has qualified for the EOC. WV-MFG has \$2,000,000 in annual taxable income and \$2,000,000 in equity, both of which are 100% apportionable to West Virginia. PA-MFG operates a manufacturing facility in Pennsylvania. PA-MFG has \$2,000,000 in annual taxable income and \$2,000,000 in equity, both of which are 100% apportionable to Pennsylvania. WV-MFG and PA-MFG currently elect to file consolidated West Virginia CNIT and BFT returns. Under the law as it existed prior to the enactment of S.B. 749, these manufacturers would have computed their West Virginia tax liability as follows:

Pre-SB 749 - West Virginia Consolidated Returns:

CNIT:	
Taxable Income	\$4,000,000
Apportionment Factor	50%
WV Taxable Income	<u>\$2,000,000</u>
WV Tax Rate	8.75%
WV CNIT	<u>\$ 175,000</u>
EOC Credit	<u>(\$175,000)</u>
	\$ 0
BFT:	
Taxable Equity	\$4,000,000
Apportionment Factor	50%

WV Taxable Equity	<u>\$2,000,000</u>
WV Tax Rate	0.55%
WV BFT	<u>\$ 11,000</u>
EOC Credit	(\$11,000)
Net WV BFT	<u>\$ 0</u>

Under the new combined filing rules of S.B. 749, these same taxpayers would end up with a significantly higher West Virginia tax liability solely because S.B. 749 limits the use of West Virginia tax credits to the specific member in the unitary group that earned the credit.

SB 749 – Combined Filing:

MFG Combined Group –	WV-MFG income or equity	\$2,000,000
	PA-MFG income or equity	\$2,000,000
	Total income or equity	<u>\$4,000,000</u>
	Apportionment factor	50%

On a combined return each member of the unitary group is required to file its own return.

<u>Combined WV CNIT</u>	<u>WV-MFG</u>	<u>PA-MFG</u>	<u>Total</u>
Income	\$2,000,000	\$2,000,000	\$4,000,000
Apportionment factor	50%	50%	50%
WV Income	<u>\$1,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>
Tax Rate	8.75%	8.75%	8.75%
WV CNIT	<u>\$ 87,500</u>	<u>\$ 87,500</u>	<u>\$ 175,000</u>
WV EOC	(\$87,500)	\$0	(\$87,500)
Net WV CNIT	<u>\$0</u>	<u>\$87,500</u>	<u>\$87,500</u>
<u>Combined WV BFT</u>	<u>WV-MFG</u>	<u>PA-MFG</u>	<u>Total</u>
Equity	\$2,000,000	\$2,000,000	\$4,000,000
Apportionment factor	50%	50%	50%
WV Equity	<u>\$1,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>
Tax Rate	0.55%	0.55%	0.55%
WV BFT	<u>\$ 5,500</u>	<u>\$ 5,500</u>	<u>\$ 11,000</u>

WV EOC	(\$ 5,500)	\$0	(\$ 5,500)
Net WV BFT	\$0	\$ 5,500	\$ 5,500

The Chamber concludes that although the general effect of SB 749 will be beneficial or neutral for many businesses, the tax credit language contained in §11-24-13c(b)(2) could adversely affect a West Virginia taxpayer’s ability to use the West Virginia tax credits for which it has previously qualified as a result of its investments in its West Virginia facilities. The Chamber is advised that such a result was not the intent of the Legislature or the Governor’s office in enacting the S.B. 749. Chamber representatives have spoken with the Secretary of Revenue about the possibility of fixing this problem during the 2008 regular session.

The Chamber believes the problem can be fixed simply by rewriting §11-24-13c(b)(2) to provide:

“(2) ~~Except where otherwise provided, no~~ A tax credit or post apportionment deduction earned by one member of the group, but not fully used by or allowed by 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 post apportionment deduction carried over to 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.”

H. Insurance Companies

(a) How Insurance Companies are Taxed --

Insurance is fundamentally different from most businesses because receipts substantially precede outlays. In commerce generally, expenses come first and income follows (e.g., manufacturers incur the costs of manufacturing before being paid for the manufactured product; and merchants purchase inventory before selling it). With respect to insurance, the reverse is true. Policyholders pay the insurance company up front, and the insurance company’s costs (primarily payment of claims and the expenses of settling claims) come afterward. Hence, state insurance regulations adopt special accounting rules that prevent insurers from treating the premiums they receive as free surplus until it is clear that they are not needed to fulfill the insurers’ obligations to their policyholders and claimants and to pay the expenses attendant on fulfilling those obligations. These accounting rules are embodied in the so-called “Annual Statement” forms which have been promulgated by the National Association of Insurance Commissioners (“NAIC”). Under the laws of every state, every insurer is required to report on its financial condition by completing and filing an Annual Statement with insurance departments in the states

in which it does business. The special accounting rules are commonly referred to as “statutory accounting” or “annual statement accounting”. In reporting their financial condition, the insurers determine the amounts that they will have to reserve to meet their insurance obligations by the use of sophisticated, highly complex actuarial methodologies and reserving formulas. The reserving methodologies and formulas for life companies differ from those for property and casualty insurers.

The federal income tax laws have also recognized that if premiums were to be taxed as they are received and deductions allowed only as the losses and expenses are paid, the effect would be to tax very large sums of money as income when in fact they might never become income because they might have to be paid out to policyholders and other claimants. It is for this reason that insurance companies compute their federal income tax liabilities under rules that are dramatically different from those generally applicable to other business corporations. Indeed, insurance companies are taxed under a separate subchapter, Subchapter L, of the Internal Revenue Code, which encompasses §§801 through 848. Subchapter L contains complex and specialized accounting and reserving provisions for the taxation of life insurance companies (§§801 through 818) and other insurance companies (primarily property and casualty companies) (§§831 through 835). This treatment is so different from the taxation of other corporate businesses that the IRS requires that insurers use tax returns which are different from those used by most other corporate businesses. Most corporations compute their federal income tax liability on Form 1120. However, life insurance companies compute their tax liability on Form 1120-L and property and casualty insurance companies compute their tax liability on Form 1120-PC.

For state tax purposes, insurance companies are generally taxed under a unique tax system. In almost all states, insurance companies are taxed on their gross premiums, rather than on their net income. Additionally, all states except Hawaii impose a retaliatory tax on “foreign insurers” (*i.e.*, insurers domiciled in states other than the taxing state), along with a variety of fees and assessments. Retaliatory taxes are measured by the excess, if any, of the tax burden imposed by the insurer’s home state over the tax burden imposed by the retaliating state. Retaliatory taxation (and its statutory progeny in other states, including reciprocal non-retaliation, reciprocal tax provisions generally, retaliatory credits) gives rise to an inter-connectedness in the nationwide insurance tax system, such that changes in one state’s insurance tax laws impact the tax treatment of insurers in other states. Because of retaliatory taxation, the forcible inclusion of insurer income in combined reports in one state threatens to ripple perniciously through the insurance tax systems in other states.

Unique and uniform accounting and financial reporting rules developed by the NAIC are used to prepare the annual statement on financial condition that is filed with each state’s insurance regulatory agency. On Schedule T and the related State Business Pages of the annual statement, insurers provide a state-by-state allocation of premiums, annuity considerations, deposits and policy holder dividends. Schedule T serves as the starting point for determining the company’s insurance premium tax for a given state, including West Virginia

Given this unique state tax system, the forced combination of insurance companies with unitary, affiliated non-insurance companies would create significant problems, not only for the insurance industry and the nationwide insurance tax system, but also for the states. In West Virginia, for

example, the State Tax Department has no experience in applying the corporate income tax to insurance companies or in addressing the multitude of interpretative, administrative and compliance complexities that would result.

In the handful of states that subject insurance companies to both an income-based tax and a premium-based tax, apportionment formulas, deductions and credits have been adopted that avoid or greatly limit the double taxation of insurance company income and provide for fair apportionment of insurance company income. For example, all insurers doing business in Florida, Illinois, Nebraska, New Hampshire, and life insurers doing business in New York are subject to both premium-based taxes and income-based taxes. With the exception of New York, each of these states allows the domestic or foreign insurance company to offset its premium tax liability by the amount of income-based tax it pays to the state, or to offset its income-based tax by the amount of premium tax it pays to the state. New York imposes both taxes on life insurance companies but provides a premium-based cap instead of an offset. Arkansas and Wisconsin impose on insurance companies both a premium-based tax and an income-based tax. However, these states exempt foreign insurance companies from paying the income-based tax. Illinois, Nebraska and New York have adopted special apportionment rules and rules for the determination of taxable income. In general, these states employ single factor apportionment using premiums to apportion taxable income.

(b) Substantive Issues Regarding Insurance Companies --

(1) Legislative Intent to Exempt Insurance Income.

Nothing in the history or purposes of SB 749 suggests that the Legislature intended to add to the current tax burden on insurance (i.e., an effective rate ranging from 3% to 4.5% of gross premium receipts, depending on the line of business) by subjecting insurance company income, for the first time, to the CNIT. To the contrary, there is every reason to believe that the Legislature intended to leave undisturbed the blanket exemption from this tax of insurance income in current law. Unless insurers are excluded from combined reports, however, a very different outcome will result.

(2) Lack of rules to determine insurer income.

It is unclear how forced combination of insurance companies could be implemented in West Virginia, where insurance companies that pay the insurance premiums tax are currently not subject to an income-based tax. Such forced combination would depend on resolving the vexing complexities of fairly determining state taxable income for insurers in the absence of any governing laws or rules. The lack of such provisions in SB 749 strongly suggests, once again, that it was not the intent of the Legislature to take this unprecedented step.

(3) Lack of appropriate apportionment rules.

The generally applied income tax apportionment factors and sourcing rules are not designed or intended to be applied to insurance companies. In recognition of this fact, insurance companies are expressly excluded from the Uniform Division of Income for Tax Purposes Act (“UDITPA”).

This results from two sections of the UDITPA. First, Section 2 provides: “Any Taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization, shall allocate and apportion his net income as provided in this Act.” (Emphasis added.) “Financial organization” is defined in Section 1(d) to mean “any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.” (Emphasis added)

Although West Virginia has not adopted the UDITPA, the state’s general apportionment rule, which is set forth in §11-24-7(e), is based on UDITPA principles and, like the UDITPA, did not apply to financial organizations under pre-SB 749 law. The major (but not the sole) difference is that West Virginia double weights the sales factor while the UDITPA equally weights the property, payroll and sales factors.

While the MTC has formulated special apportionment rules for financial organizations, which West Virginia does not follow (*see* §11-24-13b), the MTC’s rules for financial organizations do not apply to insurance companies. The MTC has not formulated model rules for apportionment of insurance company income, and that project is not one currently being undertaken by the MTC.

As a general rule, income tax apportionment factors and sourcing rules are not designed to be applied in determining local taxable values of insurance companies. In recognition of this fact, insurance companies are expressly excluded from the coverage of UDITPA. Model rules for the multistate apportionment of insurance company values for income tax purposes have not been considered, let alone formulated, to this day.

(4) Damage to Nationwide Insurance Retaliatory Tax System.

Insurance retaliatory taxation has been upheld under the Equal Protection Clause, but has been shielded from Commerce Clause challenge by the McCarran-Ferguson Act. This shield may not apply to a combined income tax return that includes insurance companies, leaving retaliatory taxation vulnerable. This would put at risk the entire state insurance tax system (a substantial and reliable revenue-generator in this state) because retaliatory tax is the glue that holds this system together.

(5) Anti-Competitive Effects.

It does not appear that SB 749 was adopted with the benefit of the Insurance Commissioner’s input concerning its potential impacts on solvency protection and other regulatory matters within the Commissioner’s purview. Nor does it appear that the Insurance Commissioner was consulted about the potential destabilizing effects of targeting the financially-strongest insurers for added tax burdens. This further suggests that it was not the intention of the Legislature to take the radical step of disturbing the blanket exemption of insurance income from the corporation net income tax.

Virtually no other state's statutes require that insurance companies (whose income is exempt from direct corporate income tax in favor of the taxation of gross premium receipts) be included in a combined income tax report with non-insurance affiliates. Furthermore, retaliatory tax uncertainties surrounding the forced inclusion of insurer income in combined reports would serve as a powerful disincentive to any insurance company contemplating domestication or expansion in West Virginia. Rather than more accurately measuring income, the forced inclusion of insurer income would distort and overtax insurer underwriting income, which already is taxed on a *gross* basis (i.e., whether the insurer is profitable or not) and at one of the highest rates in the nation. This would do nothing to improve the availability of affordable insurance in this state.

(6) Added Audit and Compliance Costs.

Forced combination of insurance companies with non-insurance companies only increases the complexity of the CNIT, which became more complex when SB 749 was enacted, requiring the worldwide combination of corporations engaging in unitary business activity in West Virginia, unless the water's-edge election is made. Combination rules have historically grown up in a non-insurance company world. Because the forced combination rules were developed without insurance companies in mind, there is an absence of case law, rulings, and virtually any guidance on how to implement worldwide combination that includes insurance companies and non-insurance companies in the same combined report or the same combined return. Therefore, income taxation through the forced combination of insurers adds layers of complexity, as well as audit and compliance costs, to a settled state tax system.

(c) *Remedial Legislation --*

The following draft amendments to SB 749 implement the objectives set out above.

(1) Amend §11-24-3a by adding a definition of the term “insurance company” to read as follows:

“(13.1) Insurance company. – The term “insurance company” means any corporation subject to taxation under section twenty-two, article three, chapter twenty-nine or chapter thirty-three of this code, or an insurance carrier subject to the surcharge imposed by subdivision (1) or (3), subsection (f), section three, article two-c, chapter twenty-three of this code, or any corporation that would be subject to taxation under any of such provisions were its business transacted in this state.”

(2) Amend §11-24-13a(h) (consolidated or combined return may be required) to read as follows:

“(h) Consolidated or combined return may be required. – The Tax Commissioner may require any person or corporation to make and file a separate return or to make and file a composite, unitary, consolidated or combined return, as the case may be, in order to

clearly reflect the taxable income of such corporations. Notwithstanding any provision to the contrary in this article, the Tax Commissioner may not require that an insurance company be included in any composite, unitary, consolidated or combined return.”

(3) Amend §11-24-13a(j) (combined reporting required) to read as follows:

“(j) *Combined reporting required.* – For tax years beginning on and after the first day of January, two thousand nine, any taxpayer engaged in a unitary business with one or more other corporations shall file a combined report which includes the income, determined under section thirteen-c or thirteen-d of this article, and the allocation and apportionment of income provisions of this article, of all corporations that are members of the unitary business, and such other information as may be required by the Tax Commissioner. Notwithstanding any provision to the contrary in this article, the income of an insurance company, the allocation or apportionment of income related thereto, and the apportionment factors of an insurance company shall not be included in a combined report filed under this article.”

(4) Amend §11-24-13d(d) to read as follows:

“(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. Except as otherwise provided, this provision shall not apply to dividends from members of the unitary business which are not part of the combined group. Notwithstanding any provision to the contrary in this article, all dividends paid by an insurance company directly or indirectly to a corporation that is part of a unitary business with the insurance company shall be deducted or eliminated from the income of the recipient of the dividend.”

(5) Amend §11-24-42 (effective date) to read as follows:

“~~The provisions of this article as amended or added by this act shall take effect on the first day of July, one thousand nine hundred eighty eight, and apply to all taxable years ending after that date beginning after the thirty-first day of December two thousand eight:~~ Provided, That if an effective date is expressly provided in such provision, that specific effective date shall control in lieu of this general effective date provision.”

I. Net Operating Loss (NOL) Carry-forwards

§11-24-13c provides rules for determining taxable income or loss in a combined report. Prior to the passage of S.B. 749 many unitary groups of related taxpayers filed consolidated CNIT and BFT returns in West Virginia. Some of these taxpayers had earned West Virginia net operating losses on a consolidated basis and at the present time have built up consolidated West Virginia net operating loss (NOL) carry-forwards. §11-24-13c(b)(1)(g) provides for the computation of NOL carryovers by individual members of unitary combined groups. This section provides that if the taxable income of an individual member of the combined group computed pursuant to this section, results in a loss for that member then such member has a West Virginia NOL subject to the NOL limitation and carryover provisions of this article. This section further provides that the West Virginia NOL can only be applied if the individual member that earned the West Virginia NOL has positive income, whether or not such taxpayer was a member of a combined reporting group in the year to which the NOL carry-forward is to be applied. As presently written, this provision may result in the loss of NOL carry-forwards by taxpayers on their combined filings which were earned during periods when consolidated returns were filed.

The Chamber concludes that the fair way of dealing with consolidated net operating loss carry-forwards earned by groups of taxpayers during years prior to the enactment of S.B. 749 would be to allow the use of such consolidated NOL carry-forwards against the tax liability of any member of a unitary combined group of taxpayers which was included in the filing of the consolidated return during the year that the West Virginia consolidated NOL's were incurred. Chamber representatives have spoken with the Secretary of Revenue about the possibility of fixing this problem during the 2008 regular legislative session.

J. Method of Filing for CNIT and BFT

§11-24-13a(e) provides:

“(e) Method of filing under this article deemed controlling for purposes of other business taxes articles.

The taxpayer shall file on the same basis under article twenty-three of this chapter as such taxpayer files under this article for the taxable year.”

"Method of filing" pertains to the tax return filed. The combined report required by SB 749 is different from a taxpayer's method of filing its annual returns. What §11-24-13a(e) means prior to SB 749 is that an affiliated group of corporations cannot file separate returns for business franchise tax purposes and elect to file a consolidated return for corporation net income tax purposes, or file a consolidated return for business franchise tax purposes and file separate returns for corporation net income tax purposes. The method of filing for BFT and CNIT purposes must be the same. Since SB 749 prohibits the filing of a consolidated CNIT return for taxable years beginning after December 31, 2008, one construction of §11-24-13a(e) is that consolidated returns are also prohibited for purposes of the BFT for taxable years beginning after December 31, 2008.

The general rule in SB 749 is that the businesses included in the required combined report will file separate CNIT returns for taxable years beginning after December 31, 2008, if the member has taxable nexus with West Virginia. However, SB 749 gives taxpayers engaged in unitary business activity the option to elect to file a combined return. New §11-24-13e provides:

“§11-24-13e. 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.” (Emphasis added)

It is unclear what §11-24-13e means. The section can be read so that the combined return is nothing more than a composite return, which means that the CNIT liability of the taxable members of the combined group on their respective shares of the unitary business income is separately determined for each member and the separately determined tax liabilities are then shown on the combined return and the aggregate tax liability so determined, is then remitted by the designation of surety. However, the designated surety does not appear to have responsibility or liability for reporting and payment of estimated CNIT during the tax year on the unitary business income of members of the combined group.

Not clear is whether the designation of surety can claim credit against the CNIT shown on the combined return for estimated CNIT paid by members of the combined group during the taxable year on their estimated West Virginia taxable income, which includes income from the unitary business activity. In determining its estimated CNIT liability, the member will take into consideration its non-business income, its business income from unitary business activity, its income from other business activity, and its allowable deductions and credits. Consequently, the estimated CNIT paid by the member may be greater than, equal to, or less than the CNIT on income from its unitary business activity apportioned to West Virginia and shown on the combined return filed under §11-24-13e.

Also unclear from the language of §11-24-13e is whether the combined return may include the non-business income, if any, of each member of the combined group and whether the combined return may include the non-unitary business income, if any, of each member of the combined group. The Chamber observes that a member of a combined group for some of its business activities may be a member or one or more other combined groups for its other business activities.

One reading is that the §11-24-13e combined return is simply a composite return of the unitary business income of the members of the combined group that have taxable nexus in West Virginia. Each member of the combined group with taxable nexus in the state will still need to file a separate return reporting (1) its business franchise tax liability; (2) the CNIT on its non-business income, if any; (3) the CNIT on its business income, if any, that is not unitary business income; and (4) the CNIT on its unitary business income and then claim credit against total CNIT for the CNIT paid, if any, on §11-24-13e combined return(s) and credit for estimated CNIT paid during the taxable year and any allowable tax credits.

In summary, the utility of new §11-24-13e is doubtful. It may well be that the §11-24-13e combined return will only be filed by combined groups that only have members that can be included in a consolidated federal return for the taxable year. Everyone else will file separate CNIT returns. If this is in fact the result, the BFT issue largely disappears.

Because of the many problems with new §11-24-13e, the Chamber believes that it either needs to be rewritten to make it a viable option for corporations, or repealed. Additionally, an affiliated group of corporations that files a consolidated federal income tax return and does not engage in unitary business activity with a corporation outside its affiliated group included in is consolidated federal return should be allowed to file a consolidated West Virginia return.

K. Water's-Edge Election

Under §11-24-13f, the members of a unitary group may elect to determine their proportionate shares of the business income of the combined group by making a “water’s-edge” election. If such election is made, the income and apportionment factors of the combined group shall include:

- (1) The entire income and apportionment factors of any member incorporated in the United States;
- (2) The entire income and apportionment factors of any member, regardless of the place incorporated, if the average of its property, payroll and sales factors within the United States is 20% or more;
- (3) The entire income and apportionment factors of any member that is a domestic international sales corporation, a foreign sales corporation or an export trade corporation;
- (4) The income and apportionment factors of any other foreign member of the combined group, to the extent its income is attributable to sources within the United States;
- (5) The income and apportionment factors of any “Controlled Foreign Corporation” to the extent that it has income defined in §952 of IRC Subpart F;

(6) The income and apportionment factors of any member that earns more than 20% 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 group, to the extent such income and apportionment factors are related thereto; and

(7) The entire income and apportionment factors of any member that is doing business in a “tax haven” as defined in §11-24-3a(25).

The Chamber believes that the use of worldwide combination as a basis for combined filing in West Virginia or the alternative, water’s-edge combination rules, will overly complicate West Virginia CNIT filings and will likely make tax returns more difficult to file and administer. Moreover, the water’s-edge rule contained in SB 749 are currently written so as to be overly expansive and will result in the taxation of the same foreign source income within the state as will worldwide combination. For that reason alone the water’s-edge rules should be eliminated.

Under the pre-SB 749 CNIT consolidated return provisions, the state had adopted a workable water’s-edge approach to consolidated filing. §11-24-13a, provided:

“(a) *Privilege to file consolidated return.*

An affiliated group of corporations (as defined for purposes of filing a consolidated federal income tax return) shall, subject to the provisions of this section and in accordance with any regulations prescribed by the tax commissioner, have the privilege of filing a consolidated return with respect to the tax imposed by this article for the taxable year in lieu of filing separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group are included in such return and consent to the filing of such return. The filing of a consolidated return shall be considered as such consent. When a corporation is a member of an affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for that part of the year during which it is a member of the affiliated group.”

By defining the West Virginia consolidated group in a manner consistent with the definition of the federal consolidated group, the income from foreign corporations not included in the federal consolidated group was eliminated from taxation in West Virginia. Thus, the water’s-edge limits of West Virginia taxation were maintained. In addition, §11-24-6 provided certain increasing and decreasing modifications dealing with the inclusion or exclusion of certain types of foreign source income. The Chamber Committee recommends that a similar rule be adopted with regard to combined filing in West Virginia.

The Chamber recommends that in lieu of the SB 749 provisions regarding water’s-edge combined filing, the statute be amended in a manner consistent with pre-SB 749 §11-24-13a. Specifically, the combined group, for purposes of filing a West Virginia combined return, should include only the affiliated group of corporations as defined for purposes of

filing a consolidated federal income tax return, with such increasing and decreasing modifications to their business income as are required to arrive at a true water's-edge determination of West Virginia combined taxable income and apportionment factors.

L. Tax Havens

§11-24-13f (water's-edge election) requires taxpayers making such an election to include the entire income and apportionment factors of any member that is doing business in a "tax haven," as defined in §11-24-3a(25), in the income and apportionment factors of the combined group. If the Chamber's recommendation is accepted that SB 749 be amended to limit the combined group for West Virginia filing purposes to the affiliated group of corporations, as defined for purposes of filing a consolidated federal income tax return, the "tax haven" definition contained in §11-24-3a(25) should also be eliminated.

IV. CONCLUSION

On June 7, 2007, State Tax Department representatives met with the WV Society of Certified Public Accountants to address a number of issues. Subsequent to the meeting, and preceding the release of this Critical Analysis, the Tax Department responded in writing to a number of questions posed at the June 7 meeting.⁸ Some of the questions touched upon Senate Bill 749 and combined reporting. In response to one question, the Department stated, “Senate Bill 749 was introduced and enacted into Law in haste and without advanced study.” The Chamber agrees.

Again, the Chamber believes that there are alternatives to the SB 749 structure that are less onerous, less complex and may well address the perceived issues regarding tax avoidance by some taxpayers.

Once again, the Chamber believes that substantial reflection should be given to the mandatory unified combined reporting provisions of SB 749 and that a host of changes must be made before they eventually take effect. The Chamber sincerely urges the Administration and the Legislature to seriously consider and act upon the findings, conclusions and recommendations contained herein.

The Chamber believes that all taxpayers should pay their fair share. That, however, should result from a tax system that is in itself fair, predictable and workable. This Critical Analysis and the recommendations contained herein are means toward that end.

⁸ The link to the “Questions and Answers from WV State Tax Department Meeting” can be found on the Society’s website, www.wvscpa.org.

APPENDIX A

**EXCERPT FROM 3/10/07 HOUSE FLOOR AMENDMENT
TO SB 749
IMPLEMENTING UNITARY COMBINED REPORTING**

**EXCERPT FROM 3/10/07 HOUSE FLOOR AMENDMENT
TO SB 749
IMPLEMENTING UNITARY COMBINED REPORTING**

(NOTE: Strike-throughs indicate language omitted from pre-SB 749 law, and underscoring indicates new language added. This is the reason that the House amendment is shown instead of the enrolled bill.)

ARTICLE 24. CORPORATION NET INCOME TAX.

§11-24-1. Legislative findings.

The Legislature hereby finds and declares that the adoption by this state for its corporation net income tax purposes of certain provisions of the laws of the United States relating to the determination of income for federal income tax purposes will: (1) Simplify preparation of state corporation net income tax returns by taxpayers; (2) improve enforcement of the state corporation net income tax through better use of information obtained from federal income tax audits; and (3) aid interpretation of the state corporation net income tax law through increased use of federal judicial and administrative determinations and precedents.

The Legislature does therefore declare that this article be construed so as to accomplish the foregoing purposes.

In recognition of the fact that corporate business is increasingly conducted on a national and international basis, it is the intent of the Legislature to adopt a combined system of income tax reporting for corporations. A separate accounting system is sometimes not adequate to accurately measure the income of multistate and multinational corporations doing business in this state and sometimes creates tax disadvantages for West Virginia corporations in competition with those multistate and multinational corporations. Therefore, it is the intent of the Legislature to capture lost revenue with adoption of a combined reporting tax base.

§11-24-3a. Specific terms defined.

For purposes of this article:

(1) *Business income.* -- The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property or the rendering of services in connection therewith constitute integral parts of the taxpayer's regular trade or business operations, and includes all income which is apportionable under the Constitution of the United States.

~~(2)~~ (3) "Combined group" means the group of all persons whose income and apportionment factors are required to be taken into account pursuant to subsection (a) or subsection (b), section thirteen-a of this article, in determining the taxpayer's share of the net business income or loss apportionable to this state.

~~(2)~~ (3) *Commercial domicile.* -- The term "commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed: *Provided*, That the commercial domicile of a financial organization, which is subject to regulation as such, shall be at the place designated as its principal office with its regulating authority.

~~(3)~~ (4) *Compensation.* -- The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

~~(4)~~ (5) *Corporation.* -- "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. The term "corporation" includes a joint- stock company and any association or other organization which is taxable as a corporation under the federal income tax law.

~~(5)~~ (6) *Delegate.* -- The term "delegate" in the phrase "or his delegate", when used in reference to the tax commissioner, means any officer or employee of the state tax department duly authorized by the tax commissioner directly, or indirectly by one or more redelegations of authority, to perform the functions mentioned or described in this article or regulations promulgated thereunder.

~~(6)~~ (7) *Domestic corporation.* -- The term "domestic corporation" means any corporation organized under the laws of West Virginia and certain corporations organized under the laws of the state of Virginia before the twentieth day of June, one thousand eight hundred sixty-three. Every other corporation is a foreign corporation.

~~(7)~~ (8) *Engaging in business.* -- The term "engaging in business" or "doing business" means any activity of a corporation which enjoys the benefits and protection of government and laws in this state.

~~(8)~~ (9) *Federal Form 1120.* -- The term "Federal Form 1120" means the annual federal income tax return of any corporation made pursuant to the United States Internal Revenue Code of 1986, as amended, or in successor provisions of the laws of the United States, in respect to the federal taxable income of a corporation, and filed with the federal Internal Revenue Service. In the case of a corporation that elects to file a federal income tax return as part of an affiliated

group, but files as a separate corporation under this article, then as to such corporation Federal Form 1120 means its pro forma Federal Form 1120.

~~(9)~~ (10) *Fiduciary*. -- The term "fiduciary" means, and includes, a guardian, trustee, executor, administrator, receiver, conservator or any person acting in any fiduciary capacity for any person.

~~(10)~~ (11) Financial organization -- The term "financial organization" means:

(A) A holding company or a subsidiary thereof. As used in this section "holding company" means a corporation registered under the federal bank holding company act of 1956 or registered as a savings and loan holding company other than a diversified savings and loan holding company (as defined in section 408(a)(1)(F) of the federal national housing act (12 U.S.C. 1730(a)(1)(F));

(B) A regulated financial corporation or a subsidiary thereof. As used in this section "regulated financial corporation" means:

(1) An institution, the deposits, shares or accounts of which are insured under the federal deposit insurance act, or by the federal savings and loan insurance corporation;

(2) An institution that is a member of a federal home loan bank;

(3) Any other bank or thrift institution incorporated or organized under the laws of a state that is engaged in the business of receiving deposits;

(4) A credit union incorporated and organized under the laws of this state;

(5) A production credit association organized under 12 U.S.C. 2071;

(6) A corporation organized under 12 U.S.C. 611 through 631 (an edge act corporation);
or

(7) A federal or state agency or branch of a foreign bank (as defined in 12 U.S.C. 3101);
or

(C) A corporation which derives more than fifty percent of its gross business income from one or more of the following activities:

(1) Making, acquiring, selling or servicing loans or extensions of credit. Loans and extensions of credit include:

- (I) Secured or unsecured consumer loans;
- (II) Installment obligations;
- (III) Mortgages or other loans secured by real estate or tangible personal property;
- (IV) Credit card loans;
- (V) Secured and unsecured commercial loans of any type; and
- (VI) Loans arising in factoring.

(2) Leasing or acting as an agent, broker or advisor in connection with leasing real and personal property that is the economic equivalent of an extension of credit (as defined by the Federal Reserve Board in 12 C.F.R. 225.25(b)(5)).

(3) Operating a credit card business.

(4) Rendering estate or trust services.

(5) Receiving, maintaining or otherwise handling deposits.

(6) Engaging in any other activity with an economic effect comparable to those activities described in item (1), (2), (3), (4) or (5) of this subparagraph.

~~(11)~~ (12) *Fiscal year.* -- The term "fiscal year" means an accounting period of twelve months ending on any day other than the last day of December, and on the basis of which the taxpayer is required to report for federal income tax purposes.

~~(12)~~ (13) *Includes and including.* -- The terms "includes" and "including" when used in a definition contained in this article shall not be deemed to exclude other things otherwise within the meaning of the term being defined.

(14) "Internal Revenue Code" means Title 26 of the United States Code, as amended without regard to application of federal treaties unless expressly made applicable to states of the United States.

~~(13)~~ (15) *Nonbusiness income.* -- The term "nonbusiness income" means all income other than business income.

(16) "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.

~~(14)~~ (17) Person. -- The term "person" is to be deemed interchangeable with the term "corporation" in this section. The term "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 the tax imposed by this article, company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee or organization of any kind.

~~(15)~~ (18) Pro forma return. -- The term "pro forma return" when used in this article means the return which the taxpayer would have filed with the Internal Revenue Service had it not elected to file federally as part of an affiliated group

~~(16)~~ (19) Public utility. -- The term "public utility" means any business activity to which the jurisdiction of the Public Service Commission of West Virginia extends under section one, article two, chapter twenty-four of this code.

~~(17)~~ (20) Sales. -- The term "sales" means all gross receipts of the taxpayer that are "business income", as defined in this section.

~~(18)~~ (21) State. -- The term "state" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States and any foreign country or political subdivision thereof.

~~(19)~~ (22) Taxable year, tax year. -- The term "taxable year" or "tax year" means the taxable year for which the taxable income of the taxpayer is computed under the federal income tax law.

~~(20)~~ (23) Tax. -- The term "tax" includes, within its meaning, interest and additions to tax, unless the intention to give it a more limited meaning is disclosed by the context.

~~(21)~~ (24) tax commissioner. -- The term "tax commissioner" means the tax commissioner of the State of West Virginia or his delegate.

(25) "Tax haven" means a jurisdiction that, for a particular tax year in question: (A) is identified by the Organization for Economic Co-operation and Development as a tax haven or as having a harmful preferential tax regime, or (B) a jurisdiction that has no, or nominal, effective tax on the relevant income; and (i) that has laws or practices that prevent effective exchange of information for tax purposes with other governments regarding taxpayers subject to, or benefiting from, the tax regime; (ii) or that lacks transparency. For purposes of this definition, a tax regime lacks transparency if the details of legislative, legal or administrative provisions are

not open to public scrutiny and apparent, or are not consistently applied among similarly situated taxpayers; (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 or other services sector relative to its overall economy. For purposes of this definition the phrase "tax regime" means a set or system of rules, laws, regulations or practices by which taxes are imposed on any person, corporation or entity, or on any income, property, incident, indicia or activity pursuant to governmental authority.

~~(22)~~ (26) *Taxpayer.* -- The term "taxpayer" means any person ~~a corporation~~ subject to the tax imposed by this article.

~~(23)~~ (27) *This code.* -- The term "this code" means the Code of West Virginia, one thousand nine hundred thirty-one, as amended.

~~(24)~~ (28) *This state.* -- The term "this state" means the State of West Virginia.

(29) "United States" means the United States of America and includes all of the states of the United States, the District of Columbia, and United States territories and possessions.

(30) "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.

~~(25)~~ (31) *West Virginia taxable income.* -- The term "West Virginia taxable income" means the taxable income of a corporation as defined by the laws of the United States for federal income tax purposes, adjusted, as provided in ~~section six~~ of this article: Provided, That in the case of a corporation having income from business activity which is taxable without this state, its "West Virginia taxable income" shall be such portion of its taxable income as so defined and adjusted as is allocated or apportioned to this state under the provisions of ~~sections seven and seven-b~~ of this article.

§11-24-7. Allocation and apportionment.

(a) *General.* -- Any taxpayer having income from business activity which is taxable both in this state and in another state shall allocate and apportion its net income as provided in this section. For purposes of this section, the term "net income" means the taxpayer's federal taxable income adjusted as provided in section six.

(b) *"Taxable in another state" defined.* -- For purposes of allocation and apportionment of net income under this section, a taxpayer is taxable in another state if:

(1) In that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax; or

(2) That state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, that state does or does not subject the taxpayer to the tax.

(c) *Business activities entirely within West Virginia.* -- If the business activities of a taxpayer take place entirely within this state, the entire net income of the taxpayer is subject to the tax imposed by this article. The business activities of a taxpayer are considered to have taken place in their entirety within this state if the taxpayer is not "taxable in another state": *Provided*, That for tax years beginning before the first day of January two thousand nine, the business activities of a financial organization having its commercial domicile in this state are considered to take place entirely in this state, notwithstanding that the organization may be "taxable in another state": *Provided, however*, That for tax years beginning before the first day of January two thousand nine, the income from the business activities of a financial organization not having its commercial domicile in this state shall be apportioned according to the applicable provisions of this article.

(d) *Business activities partially within and partially without West Virginia; allocation of nonbusiness income.* -- If the business activities of a taxpayer take place partially within and partially without this state and the taxpayer is also taxable in another state, rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income of the taxpayer, shall be allocated as provided in subdivisions (1) through (4), inclusive, of this subsection: *Provided*, That to the extent the items constitute business income of the taxpayer, they may not be so allocated but they shall be apportioned to this state according to the provisions of subsection (e) of this section and to the applicable provisions of section seven-b of this article.

(1) *Net rents and royalties.* --

(A) Net rents and royalties from real property located in this state are allocable to this state.

(B) Net rents and royalties from tangible personal property are allocable to this state:

(i) If and to the extent that the property is utilized in this state; or

(ii) In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(C) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

(2) *Capital gains.* --

(A) Capital gains and losses from sales of real property located in this state are allocable to this state.

(B) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(i) The property had a situs in this state at the time of the sale; or

(ii) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(C) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

(D) Gains pursuant to Section 631 (a) and (b) of the Internal Revenue Code of 1986, as amended, from sales of natural resources severed in this state shall be allocated to this state if they are nonbusiness income.

(3) Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

(4) *Patent and copyright royalties.* --

(A) Patent and copyright royalties are allocable to this state:

(i) If and to the extent that the patent or copyright is utilized by the payer in this state; or

(ii) If and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(B) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(C) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

(5) Corporate partner's distributive share. --

(A) Persons carrying on business as partners in a partnership, as defined in Section 761 of the Internal Revenue Code of 1986, as amended, are liable for income tax only in their separate or individual capacities.

(B) A corporate partner's distributive share of income, gain, loss, deduction or credit of a partnership shall be modified as provided in section six of this article for each partnership. For taxable years beginning on or after the thirty-first day of December, one thousand nine hundred ninety-eight, the distributive share shall then be allocated and apportioned as provided in this section, using the partnership's property, payroll and sales factors. The sum of that portion of the distributive share allocated and apportioned to this state shall then be treated as distributive share allocated to this state; and that portion of distributive share allocated or apportioned outside this state shall be treated as distributive share allocated outside this state, unless the taxpayer requests or the tax commissioner, under subsection (h) of this section requires that the distributive share be treated differently.

(e) Business activities partially within and partially without this state; apportionment of business income. -- All net income, after deducting those items specifically allocated under subsection (d) of this section, shall be apportioned to this state by multiplying the net income by a fraction, the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is four, reduced by the number of factors, if any, having no denominator.

(1) Property factor. -- The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used by it in this state during the taxable year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used by the taxpayer during the taxable year, which is reported on Schedule L Federal Form 1120, plus the average value of all real and tangible personal property leased and used by the taxpayer during the taxable year.

(2) Value of property. -- Property owned by the taxpayer shall be valued at its original cost, adjusted by subsequent capital additions or improvements thereto and partial disposition

thereof, by reason of sale, exchange, abandonment, etc.: *Provided*, That where records of original cost are unavailable or cannot be obtained without unreasonable expense, property shall be valued at original cost as determined under rules of the tax commissioner. Property rented by the taxpayer from others shall be valued at eight times the annual rental rate. The term "net annual rental rate" is the annual rental paid, directly or indirectly, by the taxpayer, or for its benefit, in money or other consideration for the use of property and includes:

(A) Any amount payable for the use of real or tangible personal property, or any part of the property, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

(B) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items.

(3) *Movable property*. -- The value of movable tangible personal property used both within and without this state shall be included in the numerator to the extent of its utilization in this state. The extent of the utilization shall be determined by multiplying the original cost of the property by a fraction, the numerator of which is the number of days of physical location of the property in this state during the taxable period, and the denominator of which is the number of days of physical location of the property everywhere during the taxable year. The number of days of physical location of the property may be determined on a statistical basis or by other reasonable method acceptable to the tax commissioner.

(4) *Leasehold improvements*. -- Leasehold improvements shall, for purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Leasehold improvements shall be included in the property factor at their original cost.

(5) *Average value of property*. -- The average value of property shall be determined by averaging the values at the beginning and ending of the taxable year: *Provided*, That the tax commissioner may require the averaging of monthly values during the taxable year if substantial fluctuations in the values of the property exist during the taxable year, or where property is acquired after the beginning of the taxable year, or is disposed of, or whose rental contract ceases, before the end of the taxable year.

(6) *Payroll factor*. -- The payroll factor is a fraction, the numerator of which is the total compensation paid in this state during the taxable year by the taxpayer for compensation, and the denominator of which is the total compensation paid by the taxpayer during the taxable year, as shown on the taxpayer's federal income tax return as filed with the Internal Revenue Service, as

reflected in the schedule of wages and salaries and that portion of cost of goods sold which reflects compensation, or as shown on a pro forma return.

(7) *Compensation.* -- The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or to any other person not properly classifiable as an employee shall be excluded. Only amounts paid directly to employees are included in the payroll factor. Amounts considered as paid directly to employees include the value of board, rent, housing, lodging and other benefits or services furnished to employees by the taxpayer in return for personal services, provided the amounts constitute income to the recipient for federal income tax purposes.

(8) *Employee.* -- The term "employee" means:

(A) Any officer of a corporation; or

(B) Any individual who, under the usual common-law rule applicable in determining the employer-employee relationship, has the status of an employee.

(9) *Compensation.* -- Compensation is paid or accrued in this state if:

(A) The employee's service is performed entirely within this state; or

(B) The employee's service is performed both within and without this state, but the service performed without the state is incidental to the individual's service within this state. The word "incidental" means any service which is temporary or transitory in nature or which is rendered in connection with an isolated transaction; or

(C) Some of the service is performed in this state and:

(i) The employee's base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state; or

(ii) The base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the employee's residence is in this state. The term "base of operations" is the place of more or less permanent nature from which the employee starts his or her work and to which he or she customarily returns in order to receive instructions from the taxpayer or communications from his or her customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his or her trade or profession at some other point or points. The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

(10) *Sales factor.* -- The sales factor is a fraction, the numerator of which is the gross

receipts of the taxpayer derived from transactions and activity in the regular course of its trade or business in this state during the taxable year (business income), less returns and allowances. The denominator of the fraction is the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business during the taxable year (business income), and reflected in its gross income reported and as appearing on the taxpayer's Federal Form 1120, and consisting of those certain pertinent portions of the (gross income) elements set forth: *Provided*, That if either the numerator or the denominator includes interest or dividends from obligations of the United States government which are exempt from taxation by this state, the amount of such interest and dividends, if any, shall be subtracted from the numerator or denominator in which it is included.

(11) Allocation of sales of tangible personal property. --

(A) Sales of tangible personal property are in this state if:

(i) The property is received in this state by the purchaser, other than the United States government, regardless of the f. o. b. point or other conditions of the sale. In the case of delivery by common carrier or other means of transportation, the place at which the property is ultimately received after all transportation has been completed is the place at which the property is received by the purchaser. Direct delivery in this state, other than for purposes of transportation, to a person or firm designated by the purchaser, is delivery to the purchaser in this state, and direct delivery outside this state to a person or firm designated by the purchaser is not delivery to the purchaser in this state, regardless of where title passes or other conditions of sale; or

(ii) The property is shipped from an office, store, warehouse, factory or other place of storage in this state and the purchaser is the United States government.

(B) All other sales of tangible personal property delivered or shipped to a purchaser within a state in which the taxpayer is not taxed, as defined in subsection (b) of this section, shall be excluded from the denominator of the sales factor.

(12) *Allocation of other sales.* -- Sales, other than sales of tangible personal property are in this state if:

(A) The income-producing activity is performed in this state; or

(B) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance; or

(C) The sale constitutes business income to the taxpayer, or the taxpayer is a financial organization not having its commercial domicile in this state, and in either case the sale is a receipt described as attributable to this state in subsection (b), section seven-b of this article.

(13) *Financial organizations and other taxpayers with business activities partially within and partially without this state.* -- Notwithstanding anything contained in this section to the contrary, in the case of financial organizations and other taxpayers, not having their commercial domicile in this state, the rules of this subsection apply to the apportionment of income from their business activities except as expressly otherwise provided in subsection (b), section seven-b of this article.

(f) *Income-producing activity.* -- The term "income-producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gain or profit. The activity does not include transactions and activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. "Income-producing activity" includes, but is not limited to, the following:

(1) The rendering of personal services by employees with utilization of tangible and intangible property by the taxpayer in performing a service;

(2) The sale, rental, leasing, licensing or other use of real property;

(3) The sale, rental, leasing, licensing or other use of tangible personal property; or

(4) The sale, licensing or other use of intangible personal property.

The mere holding of intangible personal property is not, in itself, an income-producing activity: *Provided*, That the conduct of the business of a financial organization is an income-producing activity.

(g) *Cost of performance.* -- The term "cost of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

(h) *Other methods of allocation and apportionment.* --

(1) *General.* -- If the allocation and apportionment provisions of subsections (d) and (e) of this section do not fairly represent the extent of the taxpayer's business activities in this state, the taxpayer may petition for or the tax commissioner may require, in respect to all or any part of the taxpayer's business activities, if reasonable:

(A) Separate accounting;

(B) The exclusion of one or more of the factors;

(C) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(D) The employment of any other method to effectuate an equitable allocation or apportionment of the taxpayer's income. The petition shall be filed no later than the due date of the annual return for the taxable year for which the alternative method is requested, determined without regard to any extension of time for filing the return and the petition shall include a statement of the petitioner's objections and of the alternative method of allocation or apportionment as it believes to be proper under the circumstances with such detail and proof as the tax commissioner may require.

(2) *Alternative method for public utilities.* -- If the taxpayer is a public utility and if the allocation and apportionment provisions of subsections (d) and (e) of this section do not fairly represent the taxpayer's business activities in this state, the taxpayer may petition for, or the tax commissioner may require, as an alternative to the other methods provided for in subdivision (1) of this subsection, the allocation and apportionment of the taxpayer's net income in accordance with any system of accounts prescribed by the public service commission of this state pursuant to the provisions of section eight, article two, chapter twenty-four of this code: *Provided*, That the allocation and apportionment provisions of the system of accounts fairly represent the extent of the taxpayer's business activities in this state for the purposes of the tax imposed by this article.

(3) *Burden of proof.* -- In any proceeding before the tax commissioner or in any court in which employment of one of the methods of allocation or apportionment provided for in subdivision (1) or (2) of this subsection is sought, on the ground that the allocation and apportionment provisions of subsections (d) and (e) of this section do not fairly represent the extent of the taxpayer's business activities in this state, the burden of proof is:

(A) If the tax commissioner seeks employment of one of the methods, on the tax commissioner; or

(B) If the taxpayer seeks employment of one of the other methods, on the taxpayer.

(4) For tax years beginning on or after the first day of January, two thousand nine, the provisions of section seven-a and section seven-b of this article shall be null and void and of no force or effect.

§11-24-13a. Method of filing for business taxes.

(a) *Privilege to file consolidated return.*

(1) An affiliated group of corporations (as defined for purposes of filing a consolidated federal income tax return) shall, subject to the provisions of this section and in accordance with any regulations prescribed by the tax commissioner, have the privilege of filing a consolidated

return with respect to the tax imposed by this article for the taxable year in lieu of filing separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group are included in such return and consent to the filing of such return. The filing of a consolidated return shall be considered as such consent. When a corporation is a member of an affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for that part of the year during which it is a member of the affiliated group.

(2) For tax years beginning on and after the first day of January, two thousand nine, the provisions of this subsection (a) are null and void and of no further force or effect.

(b) *Election binding.*

(1) If an affiliated group of corporations elects to file a consolidated return under this article for any taxable year ending after the thirtieth day of June, one thousand nine hundred eighty- seven, such election once made shall not be revoked for any subsequent taxable year without the written approval of the tax commissioner consenting to the revocation.

(2) For tax years beginning on and after the first day of January, two thousand nine, the provisions of this subsection (b) are null and void and of no further force or effect.

(c) *Consolidated return - financial organizations.*

An affiliated group that includes one or more financial organizations may elect under this section to file a consolidated return when that affiliated group complies with all of the following rules:

(1) The affiliated group of which the financial organization is a member must file a federal consolidated income tax return for the taxable year.

(2) All members of the affiliated group included in the federal consolidated return must consent to being included in the consolidated return filed under this article. The filing of a consolidated return under this article is conclusive proof of such consent.

(3) The West Virginia taxable income of the affiliated group shall be the sum of:

(A) The pro forma West Virginia taxable income of all financial organizations having their commercial domicile in this state that are included in the federal consolidated return, as shown on a combined pro forma West Virginia return prepared for such financial organizations; plus

(B) The pro forma West Virginia taxable income of all financial organizations not having their commercial domicile in this state that are included in the federal consolidated return, as

shown on a combined pro forma West Virginia return prepared for such financial organizations;
plus

(C) The pro forma West Virginia taxable income of all other members included in the federal consolidated income tax return, as shown on a combined pro forma West Virginia return prepared for all such nonfinancial organization members, except that income, income adjustments and exclusions, apportionment factors and other items considered when determining tax liability shall not be included in the pro forma return prepared under this paragraph for a member that is totally exempt from tax under section five of this article, or for a member that is subject to a different special industry apportionment rule provided for in this article. When a different special industry apportionment rule applies, the West Virginia taxable income of a member(s) subject to that special industry apportionment rule shall be determined on a separate pro forma West Virginia return for the member(s) subject to that special industry rule and the West Virginia taxable income so determined shall be included in the consolidated return.

(4) The West Virginia consolidated return is prepared in accordance with regulations of the tax commissioner promulgated as provided in article three, chapter twenty-nine-a of this code.

(5) The filing of a consolidated return does not distort taxable income. In any proceeding, the burden of proof that taxpayer's method of filing does not distort taxable income shall be upon the taxpayer.

(6) For tax years beginning on and after the first day of January, two thousand nine, the provisions of this subsection (c) are null and void and of no further force or effect.

(d) *Combined return.*

(1) A combined return may be filed under this article by a unitary group, including a unitary group that includes one or more financial organizations, only pursuant to the prior written approval of the tax commissioner. A request for permission to file a combined return must be filed on or before the statutory due date of the return, determined without inclusion of any extension of time to file the return. Permission to file a combined return may be granted by the tax commissioner only when taxpayer submits evidence that conclusively establishes that failure to allow the filing of a combined return will result in an unconstitutional distortion of taxable income. When permission to file a combined return is granted, combined filing will be allowed for the year(s) stated in the tax commissioner's letter. The combined return must be filed in accordance with regulations of the tax commissioner promulgated in accordance with article three, chapter twenty-nine-a of this code.

(2) For tax years beginning on and after the first day of January, two thousand nine, the provisions of this subsection (d) are null and void and of no further force or effect.

(e) Method of filing under this article deemed controlling for purposes of other business taxes articles.

The taxpayer shall file on the same basis under article twenty-three of this chapter as such taxpayer files under this article for the taxable year.

(f) Regulations.

The tax commissioner shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group or combined group of corporations filing a consolidated return, or of any unitary group of corporations filing a combined return, and of each corporation in the affiliated or unitary group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected and adjusted, in such manner as the tax commissioner deems necessary to clearly reflect the income tax liability and the income factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

(g) Computation and payment of tax.

In any case in which a consolidated or combined return is filed, or required to be filed, the tax due under this article from the affiliated, combined or unitary group shall be determined, computed, assessed, collected and adjusted in accordance with regulations prescribed by the tax commissioner, in effect on the last day prescribed by section thirteen of this article for the filing of such return, and such affiliated, combined or unitary group, as the case may be, shall be treated as the taxpayer. However, when any member of an affiliated, combined or unitary group that files a consolidated or combined return under this article is allowed to claim credit against its tax liability under this article for payment of any other tax, the amount of credit allowed may not exceed that member's proportionate share of the affiliated, combined or unitary group's precredit tax liability under this article, as shown on its pro forma return.

(h) Consolidated or combined return may be required.

The tax commissioner may require any such person or corporation to make and file a separate return or to make and file ~~corporations to make a composite, unitary, consolidated or combined return,~~ as the case may be, in order to clearly reflect the taxable income of such corporations.

(i) Effective date.

The amendments to this section made by chapter one hundred seventy-nine, acts of the Legislature in the year one thousand nine hundred ninety, shall apply to all taxable years ending after the eighth day of March, one thousand nine hundred ninety. Amendments to this article enacted by this act in the year one thousand nine hundred ninety-six, shall apply to taxable years beginning on or after the first day of January, one thousand nine hundred ninety- six, except that

financial organizations that are part of an affiliated group may elect, after the effective date of this act, to file a consolidated return prepared in accordance with the provisions of this section, as amended, and subject to applicable statutes of limitation, for taxable years beginning on or after the first day of January, one thousand nine hundred ninety-one, but before the first day of January, one thousand nine hundred ninety-six, notwithstanding provisions then in effect prohibiting out-of- state financial organizations from filing consolidated returns for those years: Provided, That when the statute of limitation on filing an amended return for any of those years expires before the first day of July, one thousand nine hundred ninety-six, the consolidated return for such year, if filed, must be filed by said first day of July.

(j) Combined reporting required.

For tax years beginning on and after the first day of January, two thousand nine, any taxpayer engaged in a unitary business with one or more other corporations shall file a combined report which includes the income, determined under section thirteen-d or thirteen-c of this article, and the allocation and apportionment of income provisions of this article, of all corporations that are members of the unitary business, and such other information as may be required by the tax commissioner.

(k) Combined reporting at tax commissioner's discretion.

(1) The tax commissioner may require the combined report to include the income and associated apportionment factors of any persons that are not included pursuant to subsection (j) of this section, but that are members of a unitary business, in order to reflect proper apportionment of income of the entire unitary businesses. The tax commissioner may require combination of persons that are not, or would not be doing business in this state pursuant to this section.

(2) If the tax commissioner determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included pursuant to subsection (j) of this section represents an avoidance or evasion of tax by such taxpayer, the tax commissioner 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.

(3) With respect to inclusion of associated apportionment factors pursuant to this section, the tax commissioner 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.

§11-24-13c. Determination of taxable income or loss using combined report.

(a) 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 this section and section thirteen-d of this article.

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

(1) 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 subsection (c) of this section,

(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 the provisions for apportionment of business income set forth in this article,

(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 subsection (g), section thirteen-d of this article,

(E) its nonbusiness income or loss allocable to this State, determined under the provisions for allocation of non-business income set forth in this article,

(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. If the taxable income computed pursuant to this section and section thirteen-d of this article results in a loss for a taxpayer member of the combined group, that taxpayer member has a West Virginia net operating loss, subject to the net operating loss limitations, and carryover provisions of this article. This West Virginia net operating loss is applied as a deduction in a prior or subsequent year only if that taxpayer has West Virginia 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.

(2) 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.

(c) 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:

(1) the business income of the combined group, determined under section thirteen-d of this article, and

(2) the taxpayer member's apportionment percentage, determined in accordance with this article, 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 thirteen-d of this article, and the denominator of which is the amount of the partnership's total unitary income.

§11-24-13d. Determination of the business income of the combined group.

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

(a) From the total income of the combined group, determined under subsection (b) of this section, subtract any income, and add any expense or loss, other than the business income, expense or loss of the combined group.

(b) 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:

(1) 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 allowable adjustments under this article.

(2) For any member not included in subdivision (1) of this subsection, 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 this article.

(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.

(3) In lieu of the procedures set forth in subdivision (2) of this subsection, and subject to the determination of the tax commissioner that it reasonably approximates income as determined under this article, any member not included in subdivision (1) of this subsection 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 tax commissioner 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 this article, the tax commissioner 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 subsection (c), section thirteen-c of this article.

(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 over 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 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.

§11-24-13e. 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.

§11-24-13f. Water's-edge election; initiation and withdrawal.

(a) Water's-edge election.

Taxpayer members of a unitary group that meet the requirements of subsection (b) of this section 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 thirteen-a of this article:

(1) 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;

(2) 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;

(3) 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;

(4) any member not described in subdivisions (1), (2) or (3) of this subsection 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;

(5) 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 ninety percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

(6) any member that earns more than twenty 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

(7) 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 set forth in the definition of a tax haven, the activity of the member shall be treated as not having been conducted in a tax haven.

(b) Initiation and withdrawal of election.

(1) 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 this article. The tax commissioner 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.

(2) Such election shall constitute consent to the reasonable production of documents and taking of depositions in accordance with the provisions of this code.

(3) In the discretion of the tax commissioner, 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 article 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.

(4) 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 ten years. It may be withdrawn or reinstated after withdrawal, prior to the expiration of the ten 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 tax commissioner. If the tax commissioner 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 ten 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 ten 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 ten year period, subject to the same conditions as applied to the original election.

§11-24-24. Credit for income tax paid to another state.

(a) Effective for taxable years beginning on or after the first day of January, one thousand nine hundred ninety-one, and notwithstanding any provisions of this code to the contrary, any financial organization, the business activities of which take place, or are deemed to take place, entirely within this state, shall be allowed a credit against the tax imposed by this article for any taxable year for taxes paid to another state. That credit shall be equal in amount to the lesser of:

(1) The taxes such financial organization shall actually have paid, which payments were made on or before the filing date of the annual return required by this article, to any other state,

and which tax was based upon or measured by the financial organization's net income and was paid with respect to the same taxable year; or

(2) The amount of such tax the financial organization would have paid if the rate of tax imposed by this article is applied to the tax base determined under the laws of such other state.

(b) Any additional payments of such tax to other states, or to political subdivisions thereof, by a financial organization described in this section, and any refunds of such taxes, made or received by such financial organization with respect to the taxable year, but after the due date of the annual return required by this article for the taxable year, including any extensions, shall likewise be accounted for in the taxable year in which such additional payment is made or such refund is received by the financial organization.

(c) For tax years beginning on or after the first day of January, two thousand nine, the provisions of this section are null and void and of no force or effect.

APPENDIX B

HOUSE BILL 4670 (2004)

ADD BACK OF CERTAIN EXPENSES

H. B. 4670

(By Delegates Michael, Doyle, Stalnaker, Boggs,

Hall, G. White and Border)

(Originating in the Committee on Finance)

[February 27, 2004]

A BILL to amend and reenact §11-24-3a of the code of West Virginia, 1931, as amended; and to amend said code by adding thereto three new sections, designated §11-24-7c, §11-24-7d and §11-24-13c, all relating generally to corporation net income tax; requiring additional adjustments to federal taxable income by certain corporations; authorizing tax commissioner to allocate income and deductions among taxpayers when necessary to properly reflect taxable income; allowing tax commissioner to require certain additional information from members of affiliated or controlled groups; and making technical changes and corrections.

Be it enacted by the Legislature of West Virginia:

That §11-24-3a of the code of West Virginia, 1931, as amended, be amended and reenacted; and that said code be amended by adding thereto three new sections, designated §11-24-7c, §11-24-7d and §11-24-13c, all to read as follows:

ARTICLE 24. CORPORATION NET INCOME TAX ACT.

§11-24-3a. Specific terms defined.

For purposes of this article:

(1) ~~*Business income.*~~—The term "~~business income~~" "Business income" means income of any type or class arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property or the rendering of services in connection therewith constitute integral parts of the taxpayer's regular trade or business operations.

(2) ~~*Commercial domicile.*~~—The term "~~commercial domicile~~" "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed: *Provided*, That the commercial domicile of a financial organization, which is subject to regulation as such, shall be at the place designated as its principal office with its regulating authority.

(3) ~~Compensation.~~—The term "~~compensation~~" "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(4) ~~Corporation.~~—The term "~~corporation~~" "Corporation" includes a joint-stock company and any association or other organization which is taxable as a corporation under the federal income tax law.

(5) ~~Delegate.~~—The term "~~delegate~~" "Delegate" in the phrase "or his delegate", when used in reference to the tax commissioner, means any officer or employee of the state tax department duly authorized by the tax commissioner directly, or indirectly by one or more redelegations of authority, to perform the functions mentioned or described in this article or regulations promulgated thereunder.

(6) ~~Domestic corporation.~~—The term "~~domestic corporation~~" "Domestic corporation" means any corporation organized under the laws of West Virginia and certain corporations organized under the laws of the state of Virginia before the twentieth day of June, one thousand eight hundred sixty-three. Every other corporation is a foreign corporation.

(7) ~~Engaging in business.~~—The term "~~engaging in business~~" "Engaging in business" or "doing business" means any activity of a corporation which enjoys the benefits and protection of government and laws in this state

(8) ~~Federal Form 1120.~~—The term "Federal Form 1120" means the annual federal income tax return of any corporation made pursuant to the United States Internal Revenue Code of 1986, as amended, or in successor provisions of the laws of the United States, in respect to the federal taxable income of a corporation, and filed with the federal Internal Revenue Service. In the case of a corporation that elects to file a federal income tax return as part of an affiliated group, but files as a separate corporation under this article, then as to such corporation Federal Form 1120 means its pro forma Federal Form 1120.

(9) ~~Fiduciary.~~—The term "~~fiduciary~~" "Fiduciary" means, and includes, a guardian, trustee, executor, administrator, receiver, conservator or any person acting in any fiduciary capacity for any person.

(10) ~~Financial organization.~~—The term "~~financial organization~~" "Financial organization" means:

(A) A holding company or a subsidiary thereof. As used in this section "holding company" means a corporation registered under the federal bank holding company act of 1956 or registered as a savings and loan holding company other than a diversified savings and loan holding company (as defined in section 408(a)(1)(F) of the federal national housing act (12 U.S.C. 1730(a)(1)(F));

(B) A regulated financial corporation or a subsidiary thereof. As used in this section, "regulated financial corporation" means:

~~(1)~~ (i) An institution, the deposits, shares or accounts of which are insured under the federal deposit insurance act, or by the federal savings and loan insurance corporation;

~~(2)~~ (ii) An institution that is a member of a federal home loan bank;

~~(3)~~ (iii) Any other bank or thrift institution incorporated or organized under the laws of a state that is engaged in the business of receiving deposits;

~~(4)~~ (iv) A credit union incorporated and organized under the laws of this state;

~~(5)~~ (v) A production credit association organized under 12 U.S.C. 2071;

~~(6)~~ (vi) A corporation organized under 12 U.S.C. 611 through 631 (an edge act corporation); or

~~(7)~~ (vii) A federal or state agency or branch of a foreign bank (as defined in 12 U.S.C. 3101); or

(C) A corporation which derives more than fifty percent of its gross business income from one or more of the following activities:

~~(1)~~ (i) Making, acquiring, selling or servicing loans or extensions of credit. Loans and extensions of credit include:

(I) Secured or unsecured consumer loans;

(II) Installment obligations;

(III) Mortgages or other loans secured by real estate or tangible personal property;

(IV) Credit card loans;

(V) Secured and unsecured commercial loans of any type; and

(VI) Loans arising in factoring.

~~(2)~~ (ii) Leasing or acting as an agent, broker or advisor in connection with leasing real and personal property that is the economic equivalent of an extension of credit (as defined by the Federal Reserve Board in 12 C.F.R. 225.25(b)(5));

~~(3)~~ (iii) Operating a credit card business;

~~(4)~~ (iv) Rendering estate or trust services;

~~(5)~~ (v) Receiving, maintaining or otherwise handling deposits; or

~~(6)~~ (vi) Engaging in any other activity with an economic effect comparable to those activities described in ~~item (1), (2), (3), (4) or (5)~~ subparagraph (i), (ii), (iii), (iv) or (v) of this ~~subparagraph~~ paragraph.

(11) ~~Fiscal year.~~—The term "~~fiscal year~~" "Fiscal year" means an accounting period of twelve months ending on any day other than the last day of December, and on the basis of which the taxpayer is required to report for federal income tax purposes.

(12) ~~Includes and including.~~—The terms "~~includes~~" "Includes" and "including" when used in a definition contained in this article shall not be deemed to exclude other things otherwise within the meaning of the term being defined.

(13) "Intangible expense" means:

(A) An expense, loss, or cost for, related to, or in connection directly or indirectly with, the direct or indirect acquisition, use, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, to the extent the expense, loss, or cost is allowed as a deduction or cost in determining taxable income for the taxable year under the Internal Revenue Code;

(B) A loss related to or incurred in connection directly or indirectly with factoring transactions or discounting transactions;

(C) A royalty, patent, technical, or copyright fee;

(D) A licensing fee; and

(E) Any other similar expense or cost.

(14) "Intangible property" means patents, patent applications, trade names, trademarks, service marks, copyrights, and similar types of intangible assets.

(15) "Interest expense" means an amount directly or indirectly allowed as a deduction under §163 of the Internal Revenue Code for purposes of determining taxable income under the Internal Revenue Code.

~~(13)~~ (16) ~~Nonbusiness income.~~—The term "~~nonbusiness income~~" "Nonbusiness income" means all income other than business income.

~~(14)~~ (17) ~~Person.~~—The term "~~person~~" "Person" is to be deemed interchangeable with the term "corporation" in this section.

~~(15)~~ (18) ~~Pro forma return.~~—The term "~~pro forma return~~" "Pro forma return" when used in this article means the return which the taxpayer would have filed with the Internal Revenue Service had it not elected to file federally as part of an affiliated group

~~(16)~~ (19) *Public utility*.—The term "~~public utility~~" "Public utility" means any business activity to which the jurisdiction of the public service commission of West Virginia extends under section one, article two, chapter twenty-four of the code of West Virginia.

(20) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is:

(A) A related entity;

(B) A component member, as defined in §1563(b) of the Internal Revenue Code; or

(C) A person to or from whom there is attribution of stock ownership in accordance with §1563(e) of the Internal Revenue Code.

(21) "Related entity" means a person that, applying the attribution rules of §318 of the Internal Revenue Code, is:

(A) A stockholder who is an individual, or a member of the stockholder's family enumerated in §318 of the Internal Revenue Code, if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially, or constructively, in the aggregate, at least fifty percent of the value of the taxpayer's outstanding stock;

(B) A stockholder, or a stockholder's partnership, limited liability company, estate, trust, or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts, and corporations own, directly, indirectly, beneficially, or constructively, in the aggregate, at least fifty percent of the value of the taxpayer's outstanding stock; or

(C) A corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of §318 of the Internal Revenue Code, if the taxpayer owns, directly, indirectly, beneficially, or constructively, at least fifty percent of the value of the corporation's outstanding stock.

~~(17)~~ (22) *Sales*.—The term "~~sales~~" "Sales" means all gross receipts of the taxpayer that are "business income", as defined in this section.

~~(18)~~ (23) *State*.—The term "~~state~~" "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

~~(19)~~ (24) *Taxable year*.—The term "~~taxable year~~" "Taxable year" means the taxable year for which the taxable income of the taxpayer is computed under the federal income tax law.

~~(20)~~ (25) *Tax*.—The term "~~tax~~" "Tax" includes, within its meaning, interest and additions to tax, unless the intention to give it a more limited meaning is disclosed by the context.

~~(21)~~ (26) Tax commissioner.—The term "~~tax commissioner~~" "Tax commissioner" means the tax commissioner of the state of West Virginia or his delegate.

~~(22)~~ (27) Taxpayer.—The term "~~taxpayer~~" "Taxpayer" means a corporation subject to the tax imposed by this article.

~~(23)~~ (28) This code.—The term "~~this code~~" "This code" means the code of West Virginia, one thousand nine hundred thirty-one, as amended.

~~(24)~~ (29) This state.—The term "~~this state~~" "This state" means the state of West Virginia.

~~(25)~~ (30) West Virginia taxable income.—The term "~~West Virginia taxable income~~" "West Virginia taxable income" means the taxable income of a corporation as defined by the laws of the United States for federal income tax purposes, adjusted, as provided in section six of this article: *Provided*, That in the case of a corporation having income from business activity which is taxable without this state, its "West Virginia taxable income" shall be such portion of its taxable income as so defined and adjusted as is allocated or apportioned to this state under the provisions of sections seven and seven-b of this article.

§11-24-7c. Additional adjustments and modifications.

(a) In addition to the adjustments and modifications under section six of this article, except as otherwise provided in this section, the amounts under subsection (b) of this section are added to the federal taxable income of a corporation to determine adjusted federal taxable income.

(b) The addition under subsection (a) of this section includes any otherwise deductible interest expense or intangible expense, if the interest expense or intangible expense is directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members.

(c) The addition required under subsection (a) of this section does not apply to any portion of an interest expense or intangible expense to the extent that the corporation establishes by clear and convincing evidence, as determined by the tax commissioner, that:

(1) The transaction giving rise to the payment of the interest expense or the intangible expense between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this title;

(2) The interest expense or the intangible expense was paid pursuant to arm's length contracts at an arm's length rate of interest or price; and

(3) During the same taxable year:

(A) The related member directly or indirectly paid, accrued, or incurred the interest expense or the intangible expense to a person who is not a related member;

(B) The related member was subject to a tax measured by its net income or receipts in this state or other states or possessions of the United States or in foreign nations;

(C) A measure of the tax imposed by this state and other states or possessions of the United States or foreign nations included the interest expense or the intangible expense received by the related member from the corporation; and

(D) The effective rate of tax paid by the related member to this state and other states or possessions of the United States or foreign nations in the aggregate on the amounts received by the related member from the corporation is equal to or greater than nine percent; or

(E) In the case of an interest expense, the corporation and the related member are financial organizations.

(d) This section may not be construed:

(1) To require a corporation to add to its federal taxable income more than once any amount of interest expense or intangible expense that the corporation pays, accrues, or incurs to a related member; or

(2) To limit or negate any other authority provided to the tax commissioner under this article or article ten of this chapter.

(e) The tax commissioner shall adopt any rules that are necessary or appropriate to carry out this section.

§11-24-7d. Allocation of income and deductions among taxpayers.

(a) The tax commissioner may distribute, apportion, or allocate gross income, deductions, credits, or allowances between and among two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, if:

(1) The organizations, trades, or businesses are owned or controlled directly or indirectly by the same interests; and

(2) The tax commissioner determines that the distribution, apportionment, or allocation is necessary in order to reflect an arm's length standard, within the meaning of §1.482-1 of regulations promulgated by the Internal Revenue Service, United States department of the treasury, and to clearly reflect the income of those organizations, trades, or businesses.

(b) The tax commissioner shall apply the administrative and judicial interpretations of §482 of the Internal Revenue Code in administering this section.

§11-24-13c. Additional requirements and information.

Each corporation that is a member of an affiliated group or a controlled group under section 1504 or section 1563 of the Internal Revenue Code shall, upon request of the tax commissioner, attach to the annual return filed under this article, or otherwise file with the tax commissioner as directed by the commissioner, a statement of all inter-member costs or expenses and all inter-member sales, exchanges, or other transactions involving tangible or intangible property for the taxable year.

(Strike-throughs indicate language that would be stricken from the present law, and underscoring indicates new language that would be added.)

BILL HISTORY:

Date	Action	Journal Page
03/04/04	To Finance	44
03/04/04	To Finance	44
03/04/04	Introduced in Senate	44
03/03/04	Communicated to Senate	1524
03/03/04	Passed House (Roll No. 417)	1524
03/03/04	Read 3rd time	1524
03/03/04	On 3rd reading with right to amend, Special Calendar	
03/02/04	Read 2nd time	1348
03/02/04	Placed on Special Calendar	
03/02/04	Removed from Consent Calendar by request	1273
03/02/04	On 2nd reading, Consent Calendar	
03/01/04	Read 1st time	1215
03/01/04	On 1st reading, Consent Calendar	
02/27/04	Do pass to Consent Calendar	1133
02/27/04	Originating in House Finance	1133

APPENDIX C

NEW YORK STATE OFFICE OF TAXATION AND FINANCE COMBINED REPORTING TAXPAYER GUIDANCE

W A Harriman Campus, Albany NY 12227 www.nystax.gov
New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Taxpayer Guidance Division

TSB-M-07(6)C
Corporation Tax
June 25, 2007

Combined Reporting for General Business Corporations

Effective for tax years beginning on or after January 1, 2007, the combined reporting rules for general business corporations subject to the tax imposed by Article 9-A of the Tax Law have been changed. Chapter 60 of the Laws of 2007 amended section 211 of the Tax Law. The amendment changes the circumstances under which a taxpayer corporation must file a combined report with other related corporations. While the Department is preparing regulations to further explain the amendments, this TSB-M outlines the Department's interpretation of the revised statute.

I. The Combined Reporting Rules

Tax Law section 211.4, as amended by Chapter 60, requires a taxpayer to file on a combined basis with related corporations, as defined below, where there are substantial intercorporate transactions among the related corporations. For a combined report to be required, it is necessary that there be substantial intercorporate transactions between the taxpayer and a related corporation or collectively, a group of such related corporations.

Use the following steps to determine whether a combined report is required and, if so, which corporations are in the combined group:

1. Every taxpayer must identify all of the corporations to which it is related. Where one or more of the related corporations are taxpayers, identify all of the corporations related to these taxpayers. Do this until all related corporations have been identified. If a taxpayer has no related corporations, it must file on a separate basis. This constitutes the Step 1 group of related corporations.
2. Identify all of the related corporations that have substantial intercorporate transactions with any taxpayer identified in Step 1. These related corporations and the taxpayers constitute the Step 2 tentative combined group.
3. Add to the Step 2 tentative combined group every related corporation that has substantial intercorporate transactions with any corporation identified in Step 2. This constitutes the Step 3 tentative combined group.

4. Add to the Step 3 tentative combined group every related corporation that has substantial intercorporate transactions with any corporation identified in Step 3. Repeat this process until it adds no more corporations to the group. This constitutes the Step 4 tentative combined group.
5. Identify each related corporation not in the Step 4 tentative combined group that has substantial intercorporate transactions with another related corporation not in the Step 4 tentative combined group. Compare all such groups and combine into one group those with common members ("unattached related group"). There may be more than one unattached related group.
6. If there are substantial intercorporate transactions between any one corporation in an unattached related group and the Step 4 tentative combined group, then all corporations in that unattached related group are included in the combined group. Do this for each unattached related group. As unattached related groups are included in the combined group, do this analysis between the expanded group and each unattached related group. The resulting group is the Step 6 tentative combined group.
7. If there are substantial intercorporate transactions between any one corporation in the Step 6 tentative combined group and an unattached related group, then all corporations in the unattached related group are included in the combined group. Do this for each unattached related group. As unattached related groups are included in the combined group, do this analysis between the expanded group and each unattached related group. The resulting group is the Step 7 tentative combined group.
8. Add to the Step 7 tentative combined group each related corporation that has substantial intercorporate transactions with the Step 7 tentative combined group.
9. Repeat the processes set forth in Steps 4, 6, 7, and 8 until no more corporations can be added to the tentative combined group.
10. Eliminate from the tentative combined group those corporations that are formed under the laws of another country (alien corporations), that are taxable pursuant to a different article of the Tax Law (or would be taxable under a different Article if subject to tax), and corporations that compute their business allocation percentage using a statutory method that is different from the taxpayer's (e.g., airline corporations and trucking corporations compute their business allocation percentage using a different business allocation percentage than manufacturing corporations). If two or more like corporations are eliminated, it is possible that they will constitute a combined group if they have substantial intercorporate transactions.

For example, one group could consist of trucking corporations and another group could consist of manufacturing corporations. However, the law provides that alien corporations are not to be included in a combined group. In addition, the Department may require or permit the taxpayer to file a combined report with one or more related corporations even where substantial intercorporate transactions are absent if a combined report is necessary to properly reflect the taxpayer's Article 9-A tax liability because of inter-company transactions or some agreement, understanding, arrangement or transaction. (See, Tax Law section 211.4(a)(4))

Where a combined report will include more than one taxpayer, the corporations included in the group must designate which of the taxpayers is to be "the taxpayer" for the purposes of computing and assessing the tax. The taxpayer so designated is often referred to as the parent corporation, even though it may not be the parent of the other related corporations included in the combined report. Where a related corporation does not have the same tax year as the parent, the related corporation's activities for its taxable year that ends during the parent's taxable year are used for purposes of reporting and filing as part of a combined report.

II. Key Terms

Related Corporation

"Related corporation" means any corporation (1) substantially all the capital stock of which is owned or controlled either directly or indirectly by the taxpayer; (2) any corporation which owns or controls directly or indirectly substantially all the capital stock of the taxpayer; and (3) any corporation the capital stock of which is owned or controlled directly or indirectly by interests that own or control directly or indirectly substantially all the capital stock of the taxpayer. "Substantially all" means ownership or control of 80 percent or more of the stock that entitles the holder thereof to vote for the election of directors and to receive dividends. The taxpayer is a related corporation.

Substantial Intercorporate Transactions

In determining whether substantial intercorporate transactions exist, the facts and circumstances of all activities and transactions between related corporations and the taxpayer must be examined, including the following: (a) manufacturing, acquiring goods or property, or performing services, for related corporations; (b) selling goods acquired from related corporations; (c) financing sales of related corporations; (d) performing related customer services using common facilities and employees for common customers of related corporations; (e) incurring expenses that benefit, directly or indirectly, one or more related corporations, and (f) transferring assets, including such assets as accounts receivable, patents or trademarks from one or more related corporations. Therefore, intercorporate receipts, intercorporate expenditures and intercorporate transfers of assets all constitute an intercorporate transaction.

Dividends are not considered in determining if there are substantial intercorporate transactions. Loans and interest on loans between related corporations are considered in determining if there are substantial intercorporate transactions. However, if the loan constitutes subsidiary capital pursuant to Tax Law section 208.4, the interest paid and received on the loan does not constitute an intercorporate transaction; but, the loan remains an asset for purposes of the substantial intercorporate asset transfer test.

Substantial Intercorporate Receipts

The substantial intercorporate transactions requirement will be satisfied where during the taxable year 50% or more of a corporation's receipts (excluding extraordinary items) are from one or more related corporations. However, if a corporation's receipts (excluding extraordinary items)

from one or more related corporations are between 45% and 55%, the multi-year test, below, applies.

Substantial Intercorporate Expenditures

The substantial intercorporate transactions requirement will be met where during the taxable year 50% or more of a corporation's expenditures, including for inventory, (but excluding extraordinary items) are from one or more related corporations. However, if a corporation's expenditures, including for inventory, (but excluding extraordinary items) from one or more related corporations are between 45% and 55%, the multi-year test, below, applies. Expenditures incurred by a corporation that directly or indirectly benefit a related corporation can constitute substantial intercorporate transactions. For example, where a related corporation is incurring expenditures that benefit another related corporation and the amount of those expenditures represent 50% or more of the expenditures of the first corporation or are equal to 50% or more of the direct and indirect expenditures of the beneficiary corporation, the substantial intercorporate transactions requirement is satisfied.

Multi-year Test

When, in a particular tax year, a corporation's intercorporate receipts during the taxable year are between 45% and 55%, the substantial intercorporate transactions requirement will be met where 50% or more of a corporation's receipts (excluding extraordinary items) during the taxable year and the prior two taxable years are from one or more related corporations. When, in a particular tax year, a corporation's intercorporate expenditures during the taxable year are between 45% and 55%, the substantial intercorporate transactions requirement will be met where 50% or more of a corporation's expenditures (excluding extraordinary items) during the taxable year and the prior two taxable years are from one or more related corporations. If one or more of the corporations involved in the intercorporate transactions did not exist for the two prior tax years, then the 50% test is to be computed using the number of months the corporations did exist.

Substantial Intercorporate Asset Transfer

A transfer of assets to a related corporation (including through incorporation) will satisfy the substantial intercorporate transactions requirement where the transferred assets constitute 10 percent or more of the transferor's or transferee's total assets at the time of the transfer and the corporations are engaged in a unitary business.

In tax years subsequent to a tax year in which there was an asset transfer between related corporations, where 50% or more of the transferee's income is from the transferred asset, the substantial intercorporate transactions requirement will be deemed satisfied.

For purposes of determining the substantiality of asset transfers, real and personal property and intangible property that is not self-created are to be valued in accordance with the rules applicable to the capital base tax as set forth in Tax Law, section 210.2. The Department will be issuing further guidance as to how to value self-created intangible property for purposes of making this substantiality determination. For purposes of this paragraph, intangible property

includes copyrights, patents, trademarks, and like property; "self-created" refers to any intangible that was created by the owner or a related corporation.

Other Considerations with Regard to Substantial Intercorporate Transactions

In determining whether the substantial intercorporate transactions requirement has been met, the Department will consider the materiality of the transactions and whether the transactions have economic substance, including the extent to which the motivation of the taxpayer in undertaking the transactions was to affect the membership of the combined group. Similar transactions must be treated in a consistent manner from year-to-year.

Service functions are not considered in determining whether there are substantial intercorporate transactions when the service functions are incidental to the business of the corporation providing such service. Service functions include, but are not limited to, accounting, legal and personnel services.

III. Examples

The references to "Steps" in the examples are references to the Steps set forth in the part I Combined Reporting Rules, above.

Basic facts for all examples (unless modified): A owns all of B, C, D, E, F, G, H, L, M, N, O, P, Q and R. All of the corporations are calendar year taxpayers for federal income tax purposes. B and C are taxable under Article 9-A of the Tax Law and the other corporations would be taxable under Article 9-A if they had nexus with NY. All of the corporations use (or would use, if subject to tax) the standard business allocation percentage. None of the corporations is an alien corporation.

Example 1: 90% of B's receipts are from D. Therefore, there are substantial intercorporate transactions between B and D. B and D are a tentative combined group and must file a combined report.

Example 2: B's receipts are: 22% from A, 20% from C, 30% from D, 10% from E and the rest are from unrelated entities. 40% of C's expenses are to B. There are no substantial intercorporate transactions here, so B and C file on a separate basis.

Example 3: 90% of B's receipts are from D and 100% of D's receipts are from E. D is an alien corporation. There are substantial intercorporate transactions between B and D, and D and E. B, D and E are a tentative combined group. However, since D is an alien corporation, it cannot be included in a combined report (see Step 10). Therefore, B and E file a combined report.

Example 4: A is the only taxpayer and 50% of A's receipts are from B, with another 4% from E. 30% of E's expenditures are to A and 20% to D. C has no transactions with anyone in the group. 50% of D's receipts are from A. 50% of F's receipts are from A. 100% of H's receipts are from F. 100% of R's receipts are from H. 20% of B's receipts are from L, 20% from M, and 20% from N. 100% of L's receipts are from M. 100% of M's receipts are from N. 40% of O's receipts are

from R and 30% are from D. 60% of P's receipts are from O. 80% of L's expenditures are to Q. All of these corporations are in the Step 1 group of related corporations because they meet the stock ownership test.

The Step 2 tentative combined group consists of A, B, D, and F. As a result of Step 3, H is added to the tentative combined group. As a result of Step 4, R is added to the tentative combined group.

As described in Step 5, L, M, N and Q is an unattached related group and O and P is an unattached related group.

Corporations O and P are added to the tentative group pursuant to Step 6 because 70% of O's receipts are from R and D. The Step 6 tentative combined group is A, B, D, F, H, R, O and P. The corporations in the unattached unrelated group of L, M, N and Q are all added to the tentative combined group pursuant to Step 7 because B has substantial intercorporate transactions with the unattached related group of L, M, N and Q. The Step 7 tentative combined group is A, B, D, F, H, R, O, P, L, M, N and Q. Pursuant to Step 8, E is added to the Step 7 tentative combined group because 30% of its expenditures are from A and 20% are from D. The Step 9 tentative combined group is the same as the Step 8 tentative combined group. Since no corporations will be excluded from the Step 9 tentative combined group pursuant to Step 10, the group of corporations that must file a combined report are A, B, D, F, H, R, O, P, L, M, N, Q and E.

Example 5: Same facts as Example 4 except that A, B, D, and F have filed on a combined basis for several years. In the current year, A realizes that it would reduce its New York State tax liability if it included C in the combined report. A creates K by contributing \$10,000 of cash to it in exchange for all of K's stock. (In the alternative, A lends \$10,000 to K, an existing dormant corporation). K enters into a contract with C to provide it with all of its office supplies (pens, paper, paper clips, etc.). K buys all of its office supplies from A and then sells them at a slight mark-up to C. In addition, K has a very small amount of interest income from a bank account. The creation of K (or, in the alternative, making K an active corporation) and the transactions of A with K and K with C are not substantial intercorporate transactions because they lack economic substance.

Example 6: A is a bakery in NY and E is a bakery in Florida. Each year, A sells E a few pieces of equipment but the transactions are not substantial from either A's or E's point of view. In a particular year, A realizes it would reduce its New York State tax liability if it included E in a combined report with it. A creates K by contributing \$10,000 to it in exchange for all of K's stock. A sells the equipment to K and K sells the equipment to E. The creation of K and the transactions of A with K and K with E are not substantial intercorporate transactions because they lack economic substance.

Example 7: A's only activity is to receive dividends from its wholly owned subsidiaries. B sells stocks, C sells municipal bonds and D sells corporate bonds. B, C and D each have their own employees. However, the employees of one corporation are authorized to and do sell extensively the securities sold by the other corporations. 80% of the receipts of B, 70% of the receipts of C and 60% of the receipts of D are generated by sales made by the common pool of employees of

B, C, and D. All three corporations carry on their activities at or using common facilities. Because there are substantial intercorporate transactions among B, C and D, they are a tentative combined group and must file a combined report. A is not included in the tentative combined group because it has no substantial intercorporate transactions with a related corporation.

NOTE: A TSB-M is an informational statement of changes to the law, regulations, or Department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in Department policies could affect the validity of the information presented in a TSB-M.