Meeting Summary

Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes

September 21, 2021, at 1:00 p.m.

Pocahontas Building, House Committee Room

https://studies.virginiageneralassembly.gov/studies/607

The Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes (the Work Group) met in Richmond with Delegate Vivian E. Watts, chair, presiding.[1] The meeting began with introductions and opening remarks followed by a presentation by Department of Taxation representatives, public comment, and discussion. Materials presented at the meeting are accessible through the Work Group's website.

Presentation: Department of Taxation

Kristin Collins, Policy Development Director, Department of Taxation
Matthew Huntley, Lead Tax Policy Analyst, Department of Taxation

Ms. Collins began the Department of Taxation presentation with a review of data submitted pursuant to Budget Item 3.5.23 of the 2021 Appropriation Act, which required corporations that are members of a unitary group with nexus in Virginia to submit an informational report to the Department of Taxation by July 1, 2021, based on taxable year 2019 data. The report was required to contain information on the unitary group's income, apportionment, computation, tax credits, and tax liabilities, with calculations based on both the Joyce and Finnigan unitary combined reporting approaches. Ms. Collins said that, of the validated reports, 73 percent showed essentially no change in tax liability, 13 percent showed an increase in tax liability, and 14 percent showed a decrease in tax liability before tax credits were applied. She noted some data limitations in the reporting, including caveats for the following: how the structure of any potential unitary combined reporting law may vary from assumptions utilized in the reports, that the estimates were based on a single year of information from taxable year 2019, and that the data was provided by taxpayers and not subject to more rigorous verification and auditing processes. Ms. Collins said that the next steps in the corporate income tax informational reporting requirement will include completing the validation process, aggregating the information, and publishing the final report to the Senate Committee on Finance and Appropriations, House Committee on Appropriations, and House Committee on Finance by December 1, 2021.

Mr. Huntley then began a discussion of unitary combined reporting issues that were raised during previous Work Group meetings and mentioned Virginia's current reporting requirements and the existing filing elections for affiliated groups of corporations (separate, consolidated

[1] **Members Present:** Delegate Vivian E. Watts (chair), Senator David W. Marsden, Brian Ball, Ellen Berenholz, David Brunori, Craig Burns, Mike Carchia, Jon Elder, Tyler Henderson, Kathleen Kittrick, Karen Lint, Alison Malloy, Greg Matson, Lori Nieto, Cassidy Rasnick, William Rowe, Gary Tappana, Tom Powers, Glen Page, Ken Wright, and Tim Winks

Members Absent: Joe Flores and Tammy Herrin

basis, or Virginia combined). He then discussed what a transition to unitary combined reporting would involve, noting that most states adopting unitary combined reporting have made it mandatory to avoid workarounds where, if other options were allowed, a taxpayer would elect the reporting method that minimizes tax liability. Delegate Watts asked whether states that enacted unitary combined reporting but also allowed a consolidated election followed the federal consolidated standards, and members of the Work Group responded that filing involves filing a federal consolidated return with state-by-state apportionment factors.

Mr. Huntley then provided an overview of North Carolina's "forced combination," which involves its Department of Revenue requesting information to substantiate intercompany transactions when it has reason to believe that a corporation failed to accurately report net income attributable to business in North Carolina through the use of intercompany transactions that lack economic substance or do not follow fair market value requirements. He explained that, based on the response, the North Carolina Department of Revenue may make certain adjustments or, if such adjustments are inadequate, can require the corporation to file a return that reflects North Carolina income on a combined basis of all members of its affiliated group that are conducting a unitary business.

Mr. Huntley then provided information about the Joyce and Finnigan methods for apportioning a unitary group's business apportionable income and noted that the Finnigan method is considered more aggressive and recently has become the more commonly adopted approach for unitary combined reporting states.

Mr. Huntley continued with a discussion of transitional issues that involve deferred gain or loss. Federal regulations defer recognition of certain gains and losses, such as those for asset transactions among affiliates in a consolidated federal return, and Mr. Huntley highlighted that recognition of gain or loss affects the basis of an asset, its subsequent depreciation, and the asset life and that implementing unitary combined reporting, especially if made mandatory, should include a transitional period to provide ample notice and guidance to taxpayers instead of an abrupt change to a new regime. He noted that there is some similarity between enforcement authority under Virginia's existing addback statute and North Carolina's forced combination in that both try to attack self-dealing in taxpayers.

Mr. Huntley then discussed the resource and auditing issues with a transition to unitary combined reporting. He estimated a required budget of $700,000 in the initial year of implementation and $400,000 annually thereafter for more staff, resources, form updates, regulatory guidance, and training but noted that the required funding would depend on the form of any law passed by the General Assembly. He also noted the possibility for increased appeals and rulings under unitary combined reporting. Delegate Watts asked how much Virginia, as a state generally conformed to federal tax law, depends on the federal regime for auditing and the extent to which Virginia could rely on federal auditors. Commissioner Craig Burns answered that Virginia does rely on the federal auditors, particularly on the corporate side, but would have to increase auditing and compliance capacity to accommodate changes to Virginia law and suggested that at least two years would be necessary to develop the new regulations and guidance for a unitary combined reporting system in Virginia.

The potential revenue issues of the transition were then discussed. Mr. Huntley noted the volatility of corporate income taxes generally and that any revenue estimate should keep that

point in mind. He added that any positive revenue impacts would likely be lower in transitional years due to taxpayer noncompliance.

Ms. Collins then addressed other corporate income tax issues raised by the Work Group during prior meetings. First, she mentioned the issue of affiliated groups switching their filing election, which must be approved by the Department of Taxation, and said that elections between separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation and are thus generally granted, while switching to or from consolidated filing status will affect those formulas and are therefore generally granted only with evidence of extraordinary circumstances. She highlighted Virginia's 20-year rule, which seeks to preserve revenues and said that shortening the time period would result in a revenue loss.

Second, Ms. Collins discussed changing Virginia's three-factor apportionment, consisting of a property, payroll, and double-weighted sales factor, along with special apportionment methods for certain taxpayers and requests for alternative apportionment methods when the statutory three-factor apportionment method is inapplicable or inequitable. She noted that Virginia also mandates single-sales factor apportionment for the share of a corporation's total profit that is taxed in Virginia based solely on the share of the corporation's sales occurring in Virginia, compared to sales everywhere, for manufacturers, retailers, enterprise data centers (if they enter into a memorandum of understanding with the Virginia Economic Development Partnership), and debt buyers.

Third, Ms. Collins delved further into market-based sourcing, explaining that Virginia's cost-of-performance apportionment structure, which was followed by a majority of states until recently, deems income producing activity and costs of performance to be performed at the location of the corporation's real and tangible property and of its employees. She also laid out the market-based sourcing bills that were introduced in the 2011, 2013, 2014, 2015, 2016, 2017, 2018, and 2020 Regular Sessions of the General Assembly and said that the revenue impact of a switch to market-based sourcing would likely be positive overall but negative in the initial years due to compliance by those corporations that benefit the most from the outset of market-based sourcing's effective date.

Fourth, Mr. Huntley discussed the issue of tracking federal consolidated return calculations on Virginia returns and mentioned that some potential changes to Virginia law could include allowing non-nexus affiliates to be included, or to require the inclusion of all affiliates, on consolidated returns, the advantages of which would include allowing a Virginia consolidated group to more closely resemble the federal consolidated group. He added that if Virginia became a unitary combined state with a consolidated election, Virginia would more closely resemble the form of the federal unitary combined group. Mr. Huntley said that the disadvantages of such a change would include transitional issues and the unknown impact on general fund revenues.

Fifth, Mr. Huntley addressed the business interest expense limitation in § 163(j) of the Internal Revenue Code, which limits deductions to 30 percent of a taxpayer's income for the taxable year under the federal Tax Cuts and Jobs Act of 2017. He said that the General Assembly conformed to that limitation in 2019 but allowed an additional 20 percent deduction in the Virginia return and mentioned that Budget Item 272(E) in the 2019 Appropriation Act required the Department of Taxation to convene a working group to study the impact of the business interest limitation on businesses that are part of an affiliated group that file a Virginia combined or consolidated return. Mr. Huntley said that the Department of Taxation issued guidelines requiring the business

interest limitation to be computed based on how taxpayers elected to file their Virginia tax return. He also noted that some options to this limitation would include changes to Virginia's current filing methods and the adoption of mandatory unitary combined reporting with a Virginia consolidated return (where the members of such return would be the same as those in the federal consolidated return) but added that such changes could result in a negative revenue impact and other fiscal implications.

Sixth, Mr. Huntley discussed the net operating loss deduction. He said that Virginia has a history of deconforming from federal provisions that enhance net operating losses. During 2019, he said, Virginia conformed to the provisions eliminating net operating loss carrybacks, allowing unlimited net operating loss carryforwards, and limiting net operating losses to 80 percent of taxable income. During the 2021 Regular Session, Virginia deconformed from the federal provisions allowing a five-year net operating loss carryback for those losses incurred in 2018, 2019, and 2020, while also removing the 80 percent limitation. Mr. Huntley stated that conforming to such federal provisions would have had a significant, negative revenue impact in Virginia.

Seventh, Mr. Huntley highlighted the addback statute implemented in Virginia in 2004 for royalty payments and similar expenses paid to an intangible holding company, explaining that the statute is intended to mitigate the impact of a tax planning structure that shelters income by setting up intangible holding companies in a state that does not tax such income. Virginia's addback statute would partially offset the positive revenue gains expected from the adoption of unitary combined reporting, but Mr. Huntley suggested considering retention of the addback, even if unitary combined reporting is adopted, in order to prevent improper income shifting outside of the Virginia unitary combined group (like international affiliates).

Finally, Mr. Huntley explained nexus considerations to the Work Group. He said that primary limitations on a state's ability to levy a tax on an out-of-state taxpayer are the United States Constitution's Commerce and Due Process clauses, which courts have interpreted to require a "substantial nexus" or sufficient connection between the taxpayer and the state seeking to impose a tax. Mr. Huntley noted that the 2018 *Wayfair* case in the Supreme Court of the United States led states to begin asserting economic nexus over out-of-state taxpayers from their in-state use of intangible property, like trademarks and trade names. He said that in addition to the substantial nexus standard, P.L. 86-272, which was passed in 1959, limits a state's ability to levy a tax on an out-of-state taxpayer. Although P.L. 86-272 does not apply to the sales of services and intangibles, Mr. Huntley said that Virginia voluntarily extended P.L. 86-272's application to the treatment of services and intangibles through administrative action.

Public Comment and Discussion of Work Plan for October Meeting

The Work Group then heard public comment. A representative for Raytheon Technologies spoke about market sourcing and said that the defense industry is comfortable with the existing three-factor apportionment method in Virginia and is particularly concerned with services rather than with property. A representative of Universal Corporation, which is headquartered in Richmond, said that the company opposes mandatory unitary combined reporting because of the potential negative growth and tax implications on the agriculture, food, and beverage industry. Finally, Molson Coors Beverage Company submitted a letter, read into the record by Delegate Watts, requesting that the Work Group reject the unitary combined reporting proposal and maintain the current system for corporate income tax reporting and collection.

The Work Group members asked the Department of Taxation representatives for the following:

- Provide the exact costs to corporations for compliance with mandatory unitary combined reporting;
- Obtain additional information on forced combination either from North Carolina's Department of Revenue or other sources;
- Provide the transitional rules on deferred gains or losses in other states;
- Determine whether Virginia's 20-year rule is an outlier and, if so, what other states use;
- Provide the gain or loss in revenue in other states that have adopted market-based sourcing; and
- Provide information on the winners and losers, percent tax change, effects on different industries, and effects on in-state businesses of a transition to unitary combined reporting.

Senator David W. Marsden urged the Work Group as its final recommendations are considered in the coming weeks to be mindful of treating businesses well and maintaining Virginia's attractive business climate while also treating businesses fairly and ensuring that tax policy is not taken advantage of. Delegate Watts expressed her intent to survey the Work Group members prior to the next meeting for written input on how to proceed on the matter of unitary combined reporting and which other tax policy issues the members wish to be addressed in the final report. She noted that the next meeting will take place in October and that members' physical presence at the meeting will be necessary in order to participate in any votes and formal recommendations.

Next Meeting

The Work Group agreed to hold its final meeting in October to develop the final findings and recommendations that are required to be submitted to the General Assembly by November 1, 2021. The exact date, time, and location were not determined.

For more information, see the *Work Group's website* or contact the Division of Legislative Services staff:

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